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(The opinions expressed in articles in The Canadian Chartered Accountant are the opinions of the writers of the articles and are not necessarily endorsed by the Association).

Editorial Comment

The Balance Sheet Made Plain

"A balance sheet," states R. H. Montgomery, "is a condensed statement of assets, liabilities and net worth or deficiency of an individual organization, or any financial entity, at a given date and in a form more or less definitely prescribed by custom." Another writer has described it as a statement of financial position and the income statement as one of progress, while still another has referred to the former as a snapshot and the latter as a moving picture. Although these definitions and comments, like many others of a similar nature in published works on accountancy, appear to the expert accountant as descriptions which should be easily comprehended, they are nevertheless not readily understood by all readers of financial reports. To not a few shareholders balance sheets and other financial statements are so difficult of comprehension and are so involved that it is little wonder that their preparation is regarded as something akin to an occult art. Accountants, company executives and boards of directors have opportunities for making clear many of the obscure features of annual statements; but how many of them are able to explain the various items of the ordinary balance sheet so that they may be understood by the shareholder? And whenever asked to do so how many would

have welcomed a description of the balance sheet in everyday language which could have been passed over to the inquirer for his perusal and edification? It is with considerable satisfaction, then, that we publish this month, as an aid to the members of the profession in their mission of enlightenment, Mr. A. E. Cutforth's fine address on "Balance sheets, their use, abuse and limitations," which he kindly sent to us immediately following its delivery before the Wandsworth Technical Institute in London, England, on 20th January last.

The Auditor's Report

Among the observations made by Mr. Cutforth in his admirable discourse, the suggestion that there is need for amending the statutory wording of the auditor's report will meet with a ready acquiescence by the members of our profession. It is obvious that the appearance in the report of such words as "true and correct view" have on occasions given rise to misunderstandings and false ideas as to their exact significance. He has therefore suggested that there be some substitution to indicate that "the balance sheet is in agreement with the books and is drawn up in accordance with proper accountancy principles." Of late the profession in Canada has been giving some thought to an improved wording of the auditor's report which will more accurately describe the nature of his examination. The profession in the United States is a step in advance of us in this regard, for in 1934 the New York Stock Exchange adopted the recommendation of the American Institute of Accountants that such a description be embodied in the auditor's report on the financial statements of companies listed on the exchange. As a result the accepted form of report is as follows:

> We have made an examination of the balance-sheet of the XYZ Company as at December 31st——, and of the statement of income and surplus for the year——. In connection therewith we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.
>
> In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under

review, its position at December 31st——, and the results of its operations for the year.

Here indeed is a choice of words describing the report in language that should be clear to any investor. In a recent address to the members of the profession at Providence, Rhode Island, John Haskell, Secretary of the Committee on Stock List of the New York Stock Exchange, expressed his entire satisfaction with the revised wording. "It calls his (the investor's) attention forcibly to the limitations in the scope of the auditor's examination," he said, "and to the fact that accounting is not an exact science. At the same time, it assures him that the accounting policies followed have been in accordance with accepted principles, and that they have been followed consistently. It provides for the red-flagging of any change in accounting policy by disclosure in the form of specific qualifications. Our records indicate that this form of uniform auditor's certificate was incorporated in more than 95% of the 1935 annual reports to stockholders received by the exchange from its listed American corporations. We hope for its hundred per cent. adoption in the reports for 1936." The use of this form of report is being used to some extent by members of the profession in Canada, and it will therefore be of interest to our readers to note numbers 1 and 2 under "comments and descriptions in annual reports of corporations" published elsewhere in this issue. Members of the profession, however, should also keep in mind the provisions of the Companies Act of the province or jurisdiction under which the company of which they are auditors has been incorporated so that their report will conform to its requirements.*

As many of our readers will want extra copies of Mr. Cutforth's address, we are having a number of offprints made, and we invite them to write us regarding them.

Co-Operative Marketing

It will be recalled that a series of five articles on Grain Accounts was written by members of the Manitoba Institute and published during 1935 in THE CANADIAN CHARTERED ACCOUNTANT. The articles were a noteworthy contribution on the subject and in particular dealt with

*For instance, the requirements respecting the "accounts and audit" of a company with a Dominion charter are contained in sections 111 to 120 of *The Companies Act 1934* (as revised 1935).

the mechanics of handling the millions of bushels of wheat grown annually on the Western prairies, and with the procedure and accounting of line grain elevator companies, terminal elevators, grain exporters and shippers, and of grain brokers and commission merchants.

The handling of Canada's immense stocks of wheat has taken on added significance since the above articles were written inasmuch as the grain growers of Western Canada have furnished a remarkable example of the possibilities of success and of failure in co-operative marketing on a large scale. An account of their experiences in this great venture has been prepared by Mr. Arthur Bloomfield, and his thesis, "The Canadian Wheat Pools: 1929-1936" is published this month.

Aims of Producers and of Consumers

The wave of oratory on co-operative enterprises which has spread into almost every section of Canada during the past year has given rise to a considerable interest in and not a little support for the movement. Instances of conspicuous success in co-operative societies are not lacking in many countries, particularly in Denmark and Sweden, and there are also similar instances on a small scale in Canada. The unfortunate thing, as far as the average address is concerned, is the undue stress which is placed upon the favourable features without giving due consideration to the numerous pitfalls in the way of successful co-operation. In almost every illustration which is cited, we note that the record of the successful consumer co-operative is advanced as proof that success awaits every group that will organize regardless of whether it is to be a consumer or a productive society. And yet, as E. D. Haliburton has very clearly pointed out in *The Dalhousie Review* (Halifax, Nova Scotia) for January, there is an obvious gulf between the two common forms of co-operatives, between the consumer and the producer types of such organization. "The purpose of the first," he says, "is always to supply goods to its members as cheaply as possible, eliminating profits or rebating them according to purchases: the purpose of the second is to sell the goods of its members to the best possible advantage. Their aims are thus diametrically opposed. Naturally in view of the economic condition which has prevailed for many years under

which the seller usually goes looking for the buyer the consumer type of co-operative has a tremendous advantage. Experience shows that the great consumer co-operatives of Europe have been definitely far more successful in achieving their aims and objects than the innumerable producer co-operatives of Canada and the United States. Every degree of combination among buyers gives them added purchasing power. But no such power accrues to sellers, simply because they have combined. They must still meet the prices at which competitors are offering their product."

How important it is then for any economic group, before deciding on a course of action, to know what they can and what they cannot hope to achieve. In the early 1920's when the Western farmers had experienced a marked slump in wheat prices, a group in one of the Western provinces succeeded in getting control of a majority of the seats in the legislature. We can vividly recall how some of the candidates in the election campaign at that time claimed that if their party won at the polls the government would set the price of wheat. There are still many people who believe that governments can by legislation remove every obstacle to the attainment of the desires of a group or a class. The western pools discovered that even if they had almost a monopoly of Canadian wheat on the British market they could not obtain a price above the world price and that when they did attempt to fix a price the English Wholesale Society, one of the world's outstanding co-operative societies and the largest millers of wheat in Great Britain, turned to Argentina and other producing countries. The British buyer in following the policy of his co-operative enterprise could not and would not permit sentiment to interfere with his purchases. The possibility and the impossibility of application of some of the theories of the co-operative enterprise are being demonstrated almost daily. From this standpoint also, Mr. Bloomfield's article is an important contribution to our published material on the subject of the Western grain trade.

The Profession In South Africa

A commission appointed in 1934 by the Governor General of the Union of South Africa to inquire into the question of the statutory registration of accountants in that Dominion has just recently issued its report.

The results of the inquiry and the recommendations of the commission will be of interest to members of the profession in Canada.

According to the report, for over thirty years an effort had been made to bring about the registration of accountants in South Africa. In 1904 the two bodies of accountants in the Transvaal joined forces and secured provincial legislation whereby no person could describe or hold himself out as a public accountant or an auditor unless he was registered in terms of the ordinance. The new organization became the Transvaal Society of Accountants and to it were admitted all *bona fide* persons in public practice at the time whether or not they could claim to be qualified. Three years later the Cape Society of Accountants and the Society of Accountants and Auditors in the Orange Free State were incorporated, but the societies in these two provinces acquired no exclusive rights to practise. The legislation passed in 1909 to incorporate the Natal Society of Accountants, however, followed closely the provisions of the Act passed in the Transvaal and thus extended the principle adopted there of requiring a public register of members. During the next ten years many efforts were made to secure uniformity of accounting practice throughout the four provinces but without any marked success, although since 1919 the four societies have made an attempt to collaborate in a number of respects. For instance, in 1921 they adopted the principle of four years' articles or six years' experience followed by examinations conducted by an examining board acting for all four provinces.

In 1927 on application of the four South African Societies the House of Assembly passed "The Chartered Accountants' Designation Act," by which public recognition was given to the fact that "by the combined efforts of the said four societies a large body of highly qualified persons has been created throughout the Union possessing a status warranting the conferring upon the individual members of the said societies of a statutory designation." The designation thus conferred on the members was chartered accountant (South Africa) or an abbreviation thereof.

Extent of Inquiry

In addition to receiving evidence from all the accounting bodies in the Union and from societies and individuals interested in the inquiry, the commission had available for its study the report of the committee of the British Board of Trade appointed in 1930 to inquire into the advisability of requiring a public register of accountants in Great Britain. It will be recalled that that committee advised against registration in the Old Land on three main grounds, namely, that there was an absence of any general public demand for registration; that there were practical difficulties in the way of setting up a compulsory register—"such as defining an accountant's functions;" and that if the practice of accountancy were restricted to those who could comply with a high standard, it was feared considerable hardship would ensue not only to those proposing to practise accountancy in its minor branches but also to clients who needing only minor accounting services would be compelled to employ more highly qualified and expensive services than were necessary.

Public Register of Accountants

In respect of this report of the Board of Trade the South African commission states that it made the points therein the subject of careful inquiry in the course of its examination of the various witnesses and the general weight of opinion was that these could not be accepted as definite objections to the principle of registration. Accordingly after a full consideration of all the evidence, both documentary and verbal, which had been presented concerning the profession in these four provinces, the commissioners came to the conclusion that the establishment of a register of accountants had become a practical and urgent necessity. They were satisfied, they said, that the societies referred to in the Chartered Accountants' Designation Act had reached and maintained a professional status of a high order, comparable to the best societies overseas, and that any measure failing to recognize this fact or tending in any way to lower that status would be contrary to the interests of the public and the profession. In consequence the commission recommended that a provisional board be established to be charged with the duty of creating a register and to act in all matters relating to the dis-

cipline and control of non-chartered accountants. It also recommended that when the duties of the provisional board had been discharged there be set up a permanent accountancy board consisting of seven members—one government nominee, one nominee from each of the four existing societies and two members appointed by the universities—which would ultimately be the only body in control of examinations and all matters connected with the profession. Domestic affairs would still be controlled by the individual societies.

To give effect to what in its opinion should be embodied in a parliamentary Act, the commission included in its report a proposed bill which if passed by the Union Government of South Africa will permit only persons registered under the Act to "engage in public practice as such, or in any manner hold himself out as or pretend to be, or make use of any words or any name, title or addition or description implying or tending to the belief that he is an accountant or public accountant or an auditor or a registered accountant and auditor or registered by law as such." This will effectively close the door against any but qualified members of the profession practising as accountants in the Union of South Africa. At the same time provision is made that this requirement will not prevent any person employed exclusively at a salary on accounts and not carrying on business on his own account from describing himself as an "accountant" in respect of or in relation to his occupation, nor prevent any person being a member of a club, institution or society which is not carried on with a view to profit, from acting in the capacity of auditor of such club, institution or society, provided no fee or other consideration is paid such person for his services.

The Initial Register

In making its recommendations regarding an initial register the commission provided for due consideration being given to existing rights which, at the passing of the proposed Act, were actually being exercised in the making of a living by the persons concerned, but such rights were not to be extended in the case of unqualified persons. On this register it was proposed to place the names of the following:

(a) All members of the four South African Chartered Societies;
(b) All persons in the Cape Province and in the Orange Free

State who have been in *bona fide* practice as public accountants during 1934 under a government license;

(c) The limited number of persons who satisfy the provisional board that they have professional qualifications of a sufficiently high standard both by examination and practical experience; and

(d) Accountants from overseas with qualifications at least equivalent to those of chartered accountants (S.A.) provided that they pass a special examination in South African law before being allowed to practise.

Opinion on Registration In Canada

The desirability of having a register of practising accountants in Canada has been discussed on occasions by a number of the provincial societies of chartered accountants, and the consensus of opinion appears to have been against any compulsion or monopoly. Chartered accountants believe that the public, generally speaking, knows how to choose, and a similar belief was expressed in the report of the committee of the Board of Trade in Great Britain to which reference has already been made. According to that report, the committee went to representatives of sections of the British public, who employ accountants, in search of evidence as to the alleged inability to distinguish the competent accountant from the incompetent, and they concluded that "for the most part the general public is not influenced or misled by the fact that an individual described himself as an 'accountant' but bases its selection of an accountant principally on personal knowledge, or local reputation." Unlike a member of the medical profession, the accountant is not called in a sudden emergency; the company or organization engaging him does so after giving due consideration to his qualifications and to the society of which he is a member.

The Imitator Ever Present

There is one situation in Canada which, we think, is to be deplored and the development of which a system of registration of accountants would doubtless have prevented—namely, the freedom with which so-called accounting societies can at present be organized by persons having little or no accounting qualifications. In making such an observation there is no intention to disparage the sincere attempt of any society formed to raise the professional standards of the public accountant, or to promote and increase the knowledge and proficiency of the great body of bookkeepers and

office assistants in this country. Most of the latter group need a wider knowledge of such subjects as higher accounting, office management, secretarial practice and economics; and the efforts of any society to encourage further study among them are to be commended, not condemned. Unfortunately, all societies are not organized with such worthy aims. Despite this situation, the public in general, as we have already remarked, can still judge of the merits of such organizations. But one aspect of this activity which we must regard as serious is the reprehensible practice of individuals who, unwilling to enter upon the rigid course of training required of chartered accountants, use professional designations which so closely resemble those of the chartered accountant that the slight difference is not readily distinguished by some sections of the public. And the situation becomes all the more serious when persons using such designations are regarded as chartered accountants. Throughout the British Dominions the educational and ethical standards of the chartered accountants' societies are high; it is in the interest of the public that they remain so and that all clandestine attempts to imitate the designation of the chartered accountant be frustrated.

The Choice of Municipal Councils

In spite of this opinion that the public in Canada will choose wisely, many sections of the community have yet to demonstrate that they have an enlightened policy in the appointment of auditors. The nine provinces of Canada have not advanced to the stage of having legislation similar to the *Municipal Corporations (Audit) Act 1933* of Great Britain. By this Act provision is made that municipal corporations, whose accounts in accordance with a statute of 1882 were to be audited by borough auditors, may by resolution appoint professional accountants as auditors. It may be a surprise to our readers to know that, by the Act of 1882, a person wholly lacking in a knowledge of accounting could be elected by the municipal council to the position of auditor in Great Britain, which position was considered more or less an honorary one. And yet a somewhat similar situation exists in Canada, for in this country municipal councils are free to appoint whom they wish as auditor regardless of whether or not the appointee has any knowledge of accounting. The

purpose of the new act of 1933 in England was to correct the anomalous situation there. It was a progressive step, and, as one member of the profession in Great Britain has expressed it, professional skill in the audit of municipal accounts is at last coming into its own.

Another serious situation is the opinion held by many municipal councils that the professional auditor is an unnecessary expense. They have deluded themselves into believing that here is one place where a council can save money, and in consequence the appointment is made without any consideration being given to competency. Even the numerous instances of defalcations by municipal treasurers have not convinced them of the need of effective checks on the revenue and expenditure of the municipality. They have also not yet learned that the professional auditor from his experience and his daily touch with all forms of industrial and commercial activity is in a position to make numerous recommendations and suggestions to municipal councils which when adopted would save for them many times the fee paid to him for his services. It is a situation that, let us hope, will be corrected in time. There are, we are glad to say, some signs of enlightened policies. Of particular interest is the action taken a few days ago by the Superintendent of Municipalities in British Columbia for a uniform system of accounting in municipalities of the province. The statement also of the Deputy Minister of Municipal Affairs of Ontario regarding the type of audit done in his province is encouraging. "Less than fifty per cent. of municipal audits of Ontario," he said at a meeting a few weeks ago of the Huron County Council at Goderich, "show a true picture of affairs in words and figures of how the taxpayers' money is being accounted for." He appealed for improved accounting and auditing and gave warning that if annual returns indicated that the reports and audits were not properly done they would be sent back to be completed in a manner satisfactory to his Department. These are hopeful signs for better accounting and more effective audits in future, all of which will be in the interests of the ratepayers.

FUND CONSCIOUSNESS — A FORGOTTEN ASPECT OF COMMERCIAL ACCOUNTANCY[1]

By William Macintosh, Chartered Accountant
Vancouver, British Columbia

THE increasing complexities of modern financial and industrial relations have of necessity given rise to manifold changes in the forms and standards of accountancy. While accountants have not been backward in making the necessary adaptations to these new relations, it may nevertheless not be amiss to inquire whether accountancy is still fulfilling its primary function of conveying to the most interested parties the true significance of the elementary financial relations of modern business.

In an article entitled "Single Entry, the Business Man's Language," Maurice E. Peloubet furnished an explanation of the failure of the lay mind to grasp the true significance of financial statements prepared from books kept by double entry. Mr. Peloubet's theme may be summed up in his own words as follows:—

> The accountant, by long training, is taught to think in terms of double-entry. That is, of course, a truism. Its corollary, however, that the business man habitually thinks in terms of single-entry, seems not to be recognized at all. . . . The distinguishing characteristic and fundamental principle of single-entry is that it deals solely with values, and with these only as affected by completed transactions or expenditures actually made. The element of profit or loss, as an abstract analytical representation, has no place in single-entry. The net result of the operations of a period is merely an increase or decrease in values at the disposal of the proprietor.[2]

The features of double entry bookkeeping, which according to Mr. Peloubet present the most difficulty to those not trained in accountancy, may be summarized as follows:

(1) In dealing with values as affected by completed transactions or actual expenditures there is also recorded an abstract causal representation or reflection of the increase or decrease in the values at the disposal of the proprietor.

[1]In *The 1936 Essay Competition*—the results of which were announced in our January issue—this essay was awarded Second Prize by the judges.

[2]*The Journal of Accountancy*, September 1927, p. 181.

(2) Entries may be made of which each side, debit and credit, is a representation and a reflection. These may be divided into the two following types:—

(a) An expression of opinion. An entry of this type, of which the creation of a reserve for depreciation is a common example, represents a statement that the management thinks, on as good evidence as is available, that the assets in question have declined in value to the extent shown by the amount of the reserve; this decline, however, has not yet affected the cash.

(b) A declaration of purpose or intent. This type consists mainly of segregations of surplus, such as reserve for equalization of dividends, reserve for extension of plant, etc. The main characteristic of the segregation is that it is made, not as an estimate of the effect of some past occurrence, but as the expression of what it is intended to do in the future with present resources.

The subject matter of Mr. Peloubet's article has been reproduced at considerable length because it constitutes an excellent epitome of the concepts involved in double entry bookkeeping. It is advisable to keep these concepts in mind when one considers the reaction of the average business man to a balance sheet. Since it is a prerequisite of a balance sheet that it be prepared from a set of books kept by double entry, it necessarily includes an item or more often several items whose significance is grasped only by an abstract mental process quite foreign to the type of mind which is accustomed to thinking in terms of the concrete facts of industry and commerce.

Statement of Application of Funds

In recent years the accountant appears to have recognized to some extent this difficulty which confronts the business man in his attempts to interpret financial statements, and has essayed to clarify his periodic statements by submitting supplementary information more or less coincident with what has come to be known as a Statement of Application of Funds. This statement which usually covers only the period under review is, in its commonest form, merely an elaboration of the equation between the change in the amount of working capital on the one hand, and the difference between the funds received from any

source whatsoever and the funds expended by way of dividends or for capital purposes (such as purchases of fixed assets or redemption of preferred shares or bonds) on the other hand. This is at least indicative of an effort to display the change in net worth during the period under review in relation to the alterations in the values of "real" accounts instead of a mere portrayal of the change in a nominal or "abstract" surplus account.

The statement of application of funds, however, has several limitations. In the first place, as stated before, it generally covers only one particular period and thus affords no cumulative data concerning the flow of funds and other changes in "real" accounts during the life history of a business. In the second place, since it is designed principally to portray changes that have taken place during a given period, it has never been used to relate these changes to or to reconcile them with the balances of funds or other "real" accounts at the close of that period. Thus, while it may be shown that expenditures have been made out of an aggregate sum consisting of funds received during the period together with a portion of previously accumulated working capital, no attempt is ever made to demonstrate that certain of these expenditures were made, for example, out of funds which would otherwise be available for dividends or out of funds which were set aside expressly or by implication for other purposes. In the third place, there are excluded from the statement (in the standard American form at least)[3] certain entries which, although they neither produce nor require the outlay of current funds, nevertheless involve transfers between distinct subdivisions of the working capital. The amortization of bond discount is an example of such an entry. By charging a portion of bond discount to profit and loss account, it is implied that funds to that extent derived from operations have been withheld from distribution as dividends and have been added to the permanent capital of the enterprise to offset part of the deficiency which arose through the assumption of a capital liability of a face value in excess of that of the assets obtained therefor. This transfer, though it is indispensable in arriving at the balances of different classes of working

[3]Cf. Knollmuller, "The Application-of-Fund Statement"—*The Journal of Accountancy*, February 1933, pp. 101-107.

capital, does not come within the scope of the statement of application of funds.

Working Capital

The need for a statement which will show a proper segregation of working capital is well exemplified in the confusion that exists in the lay mind regarding a provision for depreciation. In dealing with this matter Professor Smails has the following to say:—

> It is probable that no subject is the cause of so much misunderstanding between accountants and the lay public as is the provision for depreciation. The layman either thinks that the depreciation entries mean nothing at all or else he errs in the other direction and attaches to them a significance which they do not possess. Mr. Roger N. Carter, the Vice-President of the English Institute once put it that the depreciation charge is the measure of the amount of fixed assets which have, through the medium of product sales, become converted into liquid assets. (This is only true of course provided that the selling price of the product is sufficient to meet the depreciation charge. Any deficiency here is a straight loss of capital.) The amount so converted into liquid assets can be directed by the management of the business into any channel desired. It may be returned as cash to the owners of the business in reduction of their capital investment; it may be added to the stock of working capital; or it may be sunk once more in fixed assets either of the kind from which it was derived or some other kind.
>
> Most misunderstandings seem to originate in the common failure of management itself to realize the true nature of the depreciation adjustment, and in the resulting tendency of management to use for fixed asset extensions any liquid resources which are available, after considerations of dividends and working capital have been met. The inevitable outcome of this policy is a deficiency of liquid resources to pay for replacements of fixed assets as they become necessary, and a feeling on the part of the management, owners and the public alike that depreciation reserves are a rather inferior kind of joke.[4]

While Professor Smails finds the cause of the whole trouble to be due to misunderstanding on the part of the management and a resulting tendency to use for extensions of fixed assets any liquid resources available, it should be pointed out that a great deal of the blame must be borne by the members of the accounting profession, by reason of their failure to furnish the management periodically with statements which show the position of the various sections or funds which constitute the working capital, and thus to provide the means of more effective control over the disposition of liquid assets. In order to clarify this point

[4]*The Canadian Chartered Accountant,* February 1935, pp. 151-152.

we must consider further the ordinary procedure in relation to provision for depreciation and the possibility of obviating the abuses which Professor Smails condemns.

To revert to Mr. Peloubet's terminology, the provision for depreciation (except where renewal of fixed assets is not required owing to the limited life of an enterprise) is not only an expression of opinion as to a decline in value but also a declaration of intention to conserve a portion of the resources of the business for future use in renewal of fixed assets. In spite of the trust implied in regard to these resources we find that they are frequently expended not only for new plant units and extensions, but also for redemption of the company's bonded indebtedness.[5] It is probably safe to concur with Mr. Peloubet in concluding that any abstract entries made to indicate appropriations from surplus in respect of these expenditures, have little meaning for the average business man. The point, however, that is of most significance in this context is the fact that accountants are not in the habit of preparing statements which show the extent to which funds conserved for a specific purpose have been borrowed or used for other purposes. (It must be understood, of course, that we are here dealing with the accounts of industrial or commercial enterprises and not of governments or municipalities.)

Classification of Working Capital

The preparation of such a statement involves a new classification of working capital. The working capital of the average going concern, when classified as to its source will be found to consist as a rule of (a) funds invested either by proprietor, partners, shareholders or bondholders, and (b) funds derived from operations. The latter may be further sub-divided as to destination into funds reserved for a definite purpose such as replacement of fixed assets and funds not so reserved. It is true that it is seldom practicable to assemble into distinct funds the specific items which constitute the working capital of a concern, and it is also true that it is obviously impossible to tag each asset with a label showing its source and its proposed destination. It is nevertheless comparatively simple to make such a segregation of the aggregate working capital in the form

[5]Cases where such funds have been used to redeem preference shares are not unknown.

of a statement, and this statement may be so designed as to give a complete history of the funds of the enterprise as to source, mode of disposition (past expenditure) and intended destination if any (future expenditure). As this statement would deal with actual funds it should be more enlightening to the business man than a series of segregations of an abstract surplus account. Before giving an example of the statement indicated in the foregoing, it will be advisable to give some further particulars in regard to the composition of the various sub-divisions of working capital.

The section which represents funds invested may not always coincide with the original investment. Part of these funds may have been invested subsequently in extension of fixed assets. Again, a portion of the fixed assets may have been sold and not replaced, in which case the proceeds together with the relative amount of funds reserved by way of depreciation will be added to this section of the working capital. Another addition hereto may arise through amortization of bond discount. The effect of this has already been described in this article. Also, additional requirements for working capital may be met by the declaration of a stock dividend, which involves an increment in the funds of this section of the amount of the dividend through transfer of funds derived from operations.

The section of the working capital which is derived from operations but reserved for replacement of fixed assets should equal the aggregate of the depreciation reserves at any date. The historical representation of this sum will show the accumulated amount of the funds reserved, minus the aggregate of the amounts expended in replacement of the related assets and the sums reserved in respect of assets disposed of but not replaced. As already mentioned, these latter sums will be added to the "invested" section of the working capital. It is important, at this juncture, to draw attention to the necessity of classifying the additions to fixed assets as either replacements or new units. The replacements will be deemed to have been made by expenditure of the funds reserved for this purpose by way of depreciation together with any salvage value realized on the disposition of the assets replaced. When such funds are insufficient the balance will be provided from other sections of the working capital. Funds of this section which have

been used to finance plant extensions should be shown specifically as borrowings.

The description of the third section of the working capital commences with the funds acquired through operations after excluding therefrom the portion reserved for replacement of fixed assets. In dealing with the disposition of these funds we shall assume that the enterprise is an incorporated company. The expenditures may be grouped into four main headings as follows:

(1) Dividends

(2) Redemption of preferred shares or bonds

(3) Extensions of fixed assets

(4) Replacements of fixed assets where the aggregate of the sums provided through depreciation and the proceeds from sale of the assets is insufficient to cover the value of the new assets.

The payment of a cash dividend involves no difficulty. There is simply a reduction in the cash resources of the company to the extent of the dividend. The declaration of a stock dividend may result either in the expenditure of funds for the extension of fixed assets, or in the transfer of funds from this section to the "Investment" section, or in a combination of both. As the expenditures in the three remaining groups probably present the most complications, they warrant consideration at greater length.

Capital Surplus

Professional accountants have construed the wording of Section 61 of *The Companies Act 1934* to mean that, when funds derived from profits have been appropriated and used for the redemption of the company's preferred shares, the relative amount of such profits shall be designated as a capital surplus. This is a logical method of recording through the abstract accounts peculiar to double entry bookkeeping the decrease in the working capital derived from operations and the corresponding reduction in the outstanding share capital.[6] It would appear to have been suggested by the conventional practice in municipal accounting which recognizes that a capital surplus arises when bonds

[6]The same accounting principle is ordinarily applicable to redemptions of bonds, although the method of treating these redemptions is not regulated by *The Companies Act, 1934*.

or debentures of a municipality have been redeemed out of current funds obtained directly from the tax levy. A similar situation arises when items such as furniture, automobiles, etc., are included in the budget of a municipality and paid for out of current funds raised through levy of taxes. In the latter case capital assets have been acquired by expenditure of current funds, and thus a capital surplus has been created. Although the corresponding surplus of an incorporated company has not yet obtained recognition in *The Companies Act*, it is just as indubitably a capital surplus as the surplus referred to in Section 61 of the Act. When current funds of a company which arose through the operations of the business are expended for plant extensions, they become part of the invested capital of the company. The declaration of a stock dividend to the amount of the investment takes proper cognizance of this. If no stock dividend is declared, the logical procedure is to transfer the amount expended from earned surplus to capital surplus. As any system of fund accounting renders this procedure imperative, it will be used in the example given below. It is to be hoped that at some not too distant date it will be sanctioned by an appropriate clause in *The Companies Act*.

Similar treatment will be accorded to expenditures shown under heading (4) in the foregoing grouping. Where the deficiency in the proceeds and relative depreciation funds is made up out of funds derived from operations, a corresponding transfer to capital surplus should be made. In arriving at the amount of that transfer, allowance must be made for any profits or losses on sales of fixed assets which have been taken into the operating accounts. An illustration of this is found in the example at the end of this article. The expenditure made out of the operating fund on replacement of fixed assets is shown as $6,000.00. Operations have already been charged, however, with $4,000.00 to cover loss on sales of fixed assets and this charge has no corresponding reduction in the operating fund. Thus there remains to be transferred from earned surplus (ex operations) to capital surplus a balance of $2,000.00. The same result would be accomplished by crediting or charging direct to capital surplus the profit or loss on disposal of fixed assets and then transferring from

earned surplus to capital surplus the actual amount expended on replacements.

In order to compile a statement of the history of a company's funds in accordance with the foregoing no elaborate preparation is required. No more information is necessary than that which is usually obtained in preparing a statement of application of funds with its concomitant analysis of surplus account, except that the additions to fixed assets must be segregated into replacements and extensions. The form of the statement might be referred to as a fund balance sheet. It will bear some resemblance to municipal balance sheets and may recall to mind the old double account form of balance sheet, although it is fundamentally different from the latter. The historical form of portrayal will be used rather than the mere recording of final balances.

The Fund Balance Sheet

The data given below and the statements compiled therefrom will illustrate the fundamental principles underlying the preparations of the fund balance sheet. The formalities regarding name of the company, dates and particulars of share capital and bonds have not been observed.

Condensed original balance sheet of the company consists of:—

Fixed assets	$ 760,000	
Working capital	240,000	
Preference shares		$ 600,000
Ordinary shares		400,000
	$1,000,000	$1,000,000

Summary of transactions over a period of years:—

Bonds issued at 5% discount for purchase of new units of plant, par value	$ 500,000
Net operating profit (after bond interest, depreciation, amortization of bond discount and loss on sales of fixed assets)	185,000
Depreciation provided	267,000
Bond discount amortized	3,000
Dividends paid:	
On preference shares	$ 120,000
On ordinary shares	20,000

Additions to fixed assets:	
Ex Bond Issue	475,000
Other extensions	60,000
It will be assumed that the management has decided to borrow this sum from depreciation fund. It is obvious, of course, from the fund balance sheet Exhibit "A", that the balance of the operating fund and the addition of $3,000 to the investment working fund could also be considered available for expenditures of this nature.	
Replacements	26,000
Fixed assets sold and replaced by above:	
Cost	24,000
Depreciation provided	13,000
Proceeds from sales	7,000
Preference shares redeemed (cost $38,000) par value	40,000

The condensed balance sheet of the company after giving effect to these transactions would comprise the following items:—

Fixed assets	$1,297,000	
Working capital	442,000	
Bond discount	22,000	
Capital—Preference		$ 560,000
Capital—Ordinary		400,000
Bonds		500,000
Earned surplus		7,000
Capital surplus		40,000
Reserve for depreciation		254,000
	$1,761,000	$1,761,000

A cumulative statement of application of funds relating to the above transactions is now given:—

Funds received:		
Net profit	$ 185,000	
Add Charges to operations which did not represent outlays of working capital:		
Depreciation provided	267,000	
Bond discount amortized.	3,000	
Loss on sales of fixed assets	4,000	$ 459,000

Proceeds from bond issue		475,000
Fixed assets sold		7,000
		$941,000
Funds disbursed:		
Fixed assets purchased	561,000	
Preference shares redeemed (cost thereof)	38,000	
Dividends paid:		
On preference shares	120,000	
On ordinary shares	20,000	739,000
Increase in working capital		$ 202,000

The foregoing transactions and the relative groupings of funds are shown in the form of journal entries as follows:—

	Dr.	*Cr.*
1. Fixed assets	$760,000	
Investment—Working fund	240,000	
Preference shares		600,000
Ordinary shares		400,000
(Original set-up)		
2. Fixed assets	475,000	
Bond discount	25,000	
Bonds		500,000
(Bond issue at 5% discount)		
3. Operating fund	459,000	
Profit and loss (Earned surplus)		459,000
(Funds derived from operations)		
4. Profit and loss (Earned surplus)..	270,000	
Reserve for depreciation		267,000
Bond discount		3,000
(Depreciation provided and bond discount amortized)		
5. Depreciation fund	267,000	
Investment working fund	3,000	
Operating fund		270,000
(Fund transfers relative to entry No. 4)		

6. Profit and loss (Earned surplus) ..	140,000	
Operating fund		140,000
(Dividends paid)		
7. Fixed assets	60,000	
Depreciation fund		60,000
(Extensions purchased out of funds reserved for replacement of fixed assets)		
8. Depreciation fund (Loan)	60,000	
Loan from depreciation fund ..		60,000
(Recording loan made as per entry No. 7)		
9. Reserve for depreciation	13,000	
Depreciation fund	7,000	
Profit and loss (Earned surplus) ..	4,000	
Fixed assets		24,000
(Loss on fixed assets disposed of: cash realized therefrom recorded as part of depreciation fund)		
10. Fixed assets	26,000	
Depreciation fund		20,000
Operating fund		6,000
(Replacements of fixed assets; amount taken from depreciation fund represents accumulated depreciation on original assets sold —$13,000 plus cash received from sales $7,000; balance is taken from operating fund.)		
11. Profit and loss (Earned surplus) ..	2,000	
Capital surplus		2,000
(Reflecting expenditure of operating funds on fixed assets $6,000 less capital loss already charged to profit and loss $4,000 in entry No. 9.)		
12. Preference shares	40,000	
Capital surplus		2,000
Operating funds		38,000
(Redemption of preference shares, par value $40,000, at cost of $38,000)		

13. Profit and loss (Earned surplus) ..	38,000	
Capital surplus		38,000
(Transfer relative to entry No. 12, as required by Section 61 of *The Companies Act, 1934*).		

The fund balance sheet prepared from the above entries is appended as Exhibit "A".

No attempt has been made to bring the above groupings into conformity with legal rulings or legislative acts, except in so far as these coincide with the underlying facts of finance. Thus, the balance of earned surplus is not the amount which is legally distributable. This will be readily understood when it is emphasized that the fund balance sheet is submitted, not as a substitute for the "legal" balance sheet, but as an amplification of the customary statement of application of funds. The perusal of such an amplified statement should give the business executive a more comprehensive knowledge of the position of the working capital than the mere realization that an expenditure made for extension of plant, for example, will result in a reduction of the bank balance. It is possible that, in this manner, the misunderstandings which Professor Smails deplores may be obviated. The hope is also expressed that the fund balance sheet, by virtue of its emphasis on the segregation of assets rather than on the diverse subdivisions of that abstraction called "surplus," may be consonant with the business man's language which Mr. Peloubet has identified with the principles of single-entry.

FUND BALANCE SHEET

EXHIBIT "A"

ASSETS

INVESTMENT:				
Fixed Assets:				
Acquired by issue of share capital			$ 760,000	
Acquired by issue of bonds			475,000	
Purchased with moneys borrowed from depreciation fund			60,000	
Replacements ....$		26,000		
Less cost of assets replaced		24,000	2,000	$1,297,000
Working Fund.				
Acquired by issue of share capital			240,000	
Recovery from operating fund of portion of bond discount			3,000	243,000
				$1,540,000
DEPRECIATION FUND:				
Provided out of operating fund			267,000	
Deduct:				
Funds used to replace fixed assets sold ....$	20,000			
Less Funds received from sales thereof	7,000	13,000		
Funds advanced for extension of fixed assets		60,000	73,000	
Available balance				194,000
Loan for extension of fixed assets				60,000
				$ 254,000
OPERATING FUND:				
Total derived from operations			459,000	
Deduct:				
Portion transferred to depreciation fund		267,000		
Dividends paid on preference shares		120,000		
Dividends paid on ordinary shares		20,000		
Portion of bond discount restored to investment working fund		3,000		
Cost of redemption of preference shares		38,000		
Expenditure on replacement of fixed assets:				
Cost	26,000			
Less portion of depreciation fund applicable thereto and proceeds from sales of fixed assets	20,000	6,000	454,000	
				$ 5,000

LIABILITIES

SHARE CAPITAL:			
Preference:			
Issued ....$	600,000		
Less redeemed	40,000	$ 560,000	
Ordinary		400,000	$ 960,000
CAPITAL SURPLUS:			
Represented by preference shares redeemed (Cost $38,000 plus profit on redemption $2,000)		40,000	
Represented by operating funds invested in fixed assets		2,000	42,000
BONDS:			
Issued—Par value		500,000	
Less Discount unamortized		22,000	478,000
LOAN FROM DEPRECIATION FUND FOR EXTENSION OF FIXED ASSETS:			60,000
			$1,540,000
RESERVE FOR DEPRECIATION			254,000
			$ 254,000
EARNED SURPLUS:			
Net Profit on operations		185,000	
Deduct:			
Dividends paid:			
On preference shares	120,000		
On common shares	20,000		
Transfers to capital surplus:			
Cost of redemption of preference shares	38,000		
Expenditure on replacement of fixed assets $6,000, less loss on sales of fixed assets $4,000	2,000	180,000	
			$ 5,000

BALANCE SHEETS, THEIR USE, ABUSE AND LIMITATIONS*

By A. E. Cutforth, C.B.E., F.C.A., London, England

I HAVE found some difficulty in meeting what I conceive to be the requirements of my audience. Some of those present may know very little about balance sheets, and for their sakes I must deal with the subject in simple and non-technical language. Others whose knowledge of accountancy principles is much more extensive may feel, when I come to the end of my paper, that I have told them nothing that they did not already know.

Misconceptions About Balance Sheets

The reason why I have chosen for this address the topic of "Balance Sheets, their use, abuse and limitations" is that I felt that even among the business section of the community who may be presumed to have a very fair working knowledge of accountancy principles there is still a great deal of misconception about balance sheets. And in speaking about balance sheets I have specially in mind the balance sheets of public companies, in which the investors in this country are interested. Some people regard a balance sheet of a business as a statement which should tell one just what that business is worth as a going concern; and if it fails to do that they think that there is something wrong about it. Others, whose views go to the opposite extreme, think that balance sheets tell little or nothing; that they can be, and frequently are, framed to suit the unworthy objects of the persons who issue them, and that consequently many balance sheets are not worth the paper on which they are written.

As a matter of fact, both these extreme points of view may in part have a solid foundation; but the real truth lies somewhere between the two.

What is a Balance Sheet?

I suppose that the simplest way to describe a balance sheet is to say that it is a statement of the assets, the liabilities and the capital of a business as shown by the balances on its books. I use the term "capital" here as in-

*An address read before the Wandsworth Technical Institute, London, England, on 20th January 1937.

cluding any free reserves such, for example, as undistributed profits, as such reserves in effect form part of the capital employed in the business. The assets appear on one side of the statement, the liabilities on the other; and the figure or figures representing the capital naturally appear on the liabilities side, as the capital represents the excess of assets over liabilities. Thus the totals of the figures on each side of the balance sheet are identical; in other words, the balance sheet must balance.

Origin of Balance Sheet Figures

Now the first thing to note is that these assets and liabilities are embodied in the balance sheet at the figures *at which they appear in the books of account*; so the first question that arises in considering what a balance sheet is intended to convey is that of the bases on which assets and liabilities are brought into the books.

With liabilities the question is, as a rule, a straightforward one. If you or I owe someone some money, we know just what the amount of that liability is. There is no question of the figure at which it must appear in our books of account, and consequently in our balance sheet.

When, however, we come to the question of assets, the position is not so simple. How are assets recorded in the books of account relating to a business which we may own? At what was paid for them? Or at what we think they are worth today if we were to sell the business as a going concern? Or at what they might fetch on a forced liquidation if the business could not be sold as a whole but the assets had to be disposed of piecemeal? Unfortunately the answer cannot be given in a few words. I will therefore recall briefly the principles on which assets appear in books of account (and therefore in balance sheets) and I will then endeavour to demonstrate that although the application of these principles frequently gives unexpected results and appears at times to be inconsistent, there is no satisfactory alternative to them.

Fixed Assets and Floating Assets

As most of you know, assets can be divided into two classes, namely what are termed fixed assets and what are termed floating assets. Common examples of fixed assets are land, buildings and plant, and common examples of

floating assets are stock-in-trade, debtors and cash. Fixed assets have been described as those by means of which a business is carried on, and floating assets as those in which a business is carried on. The description is not perhaps a very illuminating one. It is important to note that the test as to whether an asset is fixed or floating is not that of the nature of the asset itself but the use to which it is put. A fixed asset need not be fixed at all in the physical sense; nor need a floating asset be in any sense movable or changeable. A steamer in the ownership of a steamship company, though it floats in the physical sense, is a fixed asset; it is an asset by means of which the steamship company carries on its business. But a boat in the hands of a company which builds boats to sell is a floating asset; it may be called part of that company's stock-in-trade. It is one of the assets in which the company carries on its business. Land is one of the most permanent and immovable things that one can imagine; but in the hands of a company whose business is the buying and selling of land, it is a floating and not a fixed asset. The question of whether under a certain set of circumstances an asset is a fixed or a floating one may be of great importance as it may affect the basis on which it is proper to hold up that asset in books of account, and consequently in balance sheets.

"Asset Values"

Having reminded you of a few simple facts and principles concerning the difference between fixed and floating assets, may I now take you on to the question of "asset values." The term "asset values" is often used or thought of somewhat loosely, as if the value of an asset was something definite and exact like the price on a ticketed article in a shop window. In the case of some assets the question of value presents no difficulty as, for instance, cash at bank in a country such as our own, or investments having a stock exchange quotation and an active market. But in the case of most assets there is, in a greater or less degree, room for difference of opinion as to their true value at any particular time. When we speak of the commercial value of something which we own as being £X, we obviously mean that we can expect to receive £X in cash for it if we were to sell it. But a question which at once arises is "Under

what conditions are we supposed to be selling it?" If it forms part of other assets comprised in a business, are we selling it with the business as a whole, or in the ordinary course of business, or is the selling of it part of the process of breaking up the business and selling the assets piecemeal to various people? The value under the first alternative may well be very different from the value under the second. Another question to be asked is—in placing a value on the asset, are we to assume that a buyer could be found who is as anxious to buy as we are to sell; or are we to assume that the buyer does not particularly care whether he buys or not and would only do so at some rock-bottom kind of a price? Furthermore, are we to assume that we can take our time in finding a buyer, or alternatively that we must sell within a very short time? This point may materially affect the question of price.

But even if in regard to a particular asset the basis of the valuation was defined, such as, for example, "the value as part of a going concern, and assuming a sale by a willing seller to a willing buyer," the value itself may be largely a matter of opinion. You may ask a well-known surveyor and valuer to put a value on some land, works and plant on the basis of their forming part of a going concern earning reasonable profits, and on the basis of a transaction between a willing buyer and a willing seller; and that surveyor may value them at, say, £175,000. And you may ask another equally well-known surveyor to do the same thing and he may give you a figure of, say, £225,000. Similarly in regard to the intangible asset of the goodwill of a business, which professional accountants are frequently called in to assess, one eminent accountant may give you a figure of £170,000, and another equally eminent accountant with the same instructions, and with the same data upon which to work, may calculate a figure of £230,000. You will see that I have put a wider margin between the two accountants' figures than between the two surveyors' figures; but I hasten to add that one naturally tries to be modest about the value of the opinions expressed by the members of one's own profession!

I hope I have proved to you that in regard to many kinds of assets there are various alternative bases on which it is possible to value them; and further that even if the

basis of valuation is defined beforehand, there is in regard to certain classes of assets room for considerable difference of opinion as to what the fair value may be.

I now return to the question of balance sheets. On what basis are assets included in these? The answer is that this depends on the kind of asset; but it can at once be said that the basis is not that of the value that might be realized on a forced sale of the individual assets—in other words, a break-up price.

Floating Assets in Balance Sheets

In regard to floating assets generally it can be stated that these appear in the books of account, and consequently in the balance sheet, at their current worth as part of the assets of a going concern. Book debts, for example, appear at the amount owing by the debtors less any reserve considered necessary in respect of discounts and doubtful debts; in other words, the net figure included in the balance sheet is the sum expected to be realized for the book debts as a whole. Stocks of goods held for sale are brought into the balance sheet at what they cost subject to any reserves in respect of obsolescent or damaged goods, and subject to a further reserve if the market value at the date of the balance sheet is less than cost. An exception to this principle occurs in the case of concerns whose function is the production of commodities for which there is a market quotation. For example, a rubber plantation company which found itself at the end of its financial year with certain stocks of rubber in hand and unsold would value the stock at the current market price of rubber less the estimated cost of selling it. The reason for this is that the whole of the efforts of the plantation company are directed towards the *production* of the rubber; the selling can be effected by a stroke of the pen at the current quotation on the rubber market. This treatment is quite inappropriate where the chief or an important function of the company is that of the disposal of the commodity or article which it has purchased or manufactured. In such a case no profit can be taken credit for on stock which has not been sold—in other words, the goods must not be valued for balance sheet purposes at a figure in excess of cost. For example, Morris Motors would not think of valuing its completed but unsold cars at the balance sheet date at what it believed it was

going to get for them. It would value them at what they cost to produce. The mere production of cars does not ensure their being sold; and an important function of motor manufacturing businesses is that of selling the cars. Similarly, Messrs. Selfridge would not value their gloves or stockings or handkerchiefs for balance sheet purposes at what they believed they were going to get for them. They could buy them from manufacturers in bulk almost by a stroke of the pen. Their main energies are directed to the selling of them piecemeal to their customers. They could not therefore take their stock of unsold goods into their balance sheet at anything in excess of cost.

The only other observation I would make on the basis of valuing stock-in-trade for balance sheet purposes is to remind you that the basis is that of an asset which forms part of a going concern, and that this basis will probably result in a much higher figure being attributed to the stock than if the basis of "break-up" value had been adopted. One meets with or hears of cases very frequently where a trading business has been unsuccessful and has gone into liquidation; it has not been possible to sell the undertaking as a going concern, and the stock has in consequence had to be disposed of piecemeal by auction or some other similar means. In such circumstances it invariably happens that the figure realized by the stock, which may be in perfectly good condition, is something very much less than such stock originally cost. Unless, however, there is a likelihood of the stock owned by a business having to be disposed of in this special and very unsatisfactory manner, such a basis of valuation is not appropriate for balance sheet purposes.

Fixed Assets in Balance Sheets

I now pass to the question of values at which what are called fixed assets appear in books of account and therefore in balance sheets. Speaking in general terms it may be said that these appear at what they have cost less any sums which those who own or control the business regard as a proper provision in respect of depreciation or obsolescence.

This basis, as you will readily appreciate, sometimes results in a figure being attributed to a fixed asset which may be very far removed from the current value of that asset as forming part of a going concern. In other words,

it might be very dangerous to assume that the current worth of a business—that is to say, the amount which can be realized by the sale of it as a whole—would be approximately equal to the total of its assets as appearing in its balance sheet, less its liabilities. It is conceivable that the land owned by a business may have appreciated very much in value since it was first acquired; it is also conceivable that liberal rates of depreciation applied by the owners of a business over a series of years to assets such as buildings and plant may have resulted in those assets being written down in the books to figures very much lower than their current going concern value. On the other hand it may be that there is obsolescence in the plant and machinery of the business which the rates of depreciation applied to reduce the book value of this asset have proved insufficient to cover and that as a result the plant and machinery appears in the books at a figure considerably in excess of what a purchaser would give for it in acquiring the business, bearing in mind the more up-to-date types of plant and machinery now available.

But probably the largest difference of all between balance sheet values and current going concern values arises in connection with that intangible but nevertheless very real asset known as goodwill. An individual or a firm or a company may found a business which becomes in time so profitable that it has created for itself a goodwill. In other words, the business, because of its profitability, has acquired in course of time a value greatly exceeding the total current value of what may be termed its tangible assets less its liabilities. That goodwill does not, of course, appear in its balance sheet at all. Similarly a business may have taken out patents or obtained concessions or rights which, as the origin of profits, have in due course a value vastly exceeding the sum of money which may have been spent upon them.

Frequently, of course, the boot is on the other leg. A firm or company may have purchased a business having a valuable goodwill, and in consequence a substantial part of the total purchase price is attributable to that particular asset. In the hands of the purchaser the profitability of the business may have declined; and in consequence the goodwill may in course of time be worth very much less than was the case when the business changed hands—in

fact it may have ceased to have any value at all. The new owners may, as a matter of policy, choose to apply some portion of the annual profits of the business in writing down the figure of goodwill; but in practice one finds that in circumstances like these, in which profits are dwindling, there is less disposition to apply any part of them in writing down intangible assets like goodwill than there is when profits are rising, although in the latter event the goodwill will presumably have a value at least equal to and probably exceeding the figure at which it appears in the balance sheet, i.e. the figure which was originally paid in respect of it.

One thing is certain, and that is that those controlling or administering the business will not make any attempt, year by year, to re-value the goodwill and to write off to profit and loss account any excess of the book figure over the figure representing the estimated value.

Balance Sheet Not a Valuation Statement

To sum up on the question of fixed assets, and particularly of goodwill:—In very many cases the current value of a business—though to a considerable degree a matter of opinion—is very largely in excess of the figure represented by the total book values of its assets less the total of its liabilities. And in many other cases the converse is true, namely that the current value of a business falls very far short of the book value of its assets less liabilities.

Your natural comment is "Must these things be?"

In reply I would ask you to consider the alternative. The alternative is that some person or body of persons should, at each balance sheet date, make, to the best of their ability, a valuation of the assets comprised in the business, and that where the valuation figure in respect of any asset was greater than the figure appearing in the books of account the latter figure should be written up to the valuation figure, and correspondingly, where the valuation figure in respect of an asset was less than the book figure, the book figure should be written down to the valuation figure. As the books are kept on the double entry system, these adjustments in the balances representing assets would involve corresponding entries to the debit or credit of some other account or accounts. One would therefore have to visualize on the valuation balance sheet an item on the capital and

liabilities side of this statement called "Reserve representing excess arising on revaluation of certain assets as at the date of the balance sheet" or an item on the assets side "Loss or deficiency arising on the revaluation of certain assets as at the date of the balance sheet."

In the case of public companies, the obvious persons who would be made responsible for such valuations would be the directors. In the first place, would it be fair to place such a responsibilty on any board of directors as part of their annual duties? Would it be likely in practice that directors would be prepared to shoulder such responsibility without protecting themselves by calling in expert valuers to advise them in regard to certain of the classes of assets, thus entailing considerable annual expense? Furthermore, is it likely that a board of, say, five directors will in the great majority of cases be able to agree as to what the fair value of certain assets is? And what is to happen if they do not all agree? Further, what would be the effect on shareholders' minds if they see—as they might very likely do—large variations in the value attributed to the goodwill of a company's business as between one year and another? And how would the quotations of a company's shares on the stock exchanges be affected? Honest and competent directors would in practice presumably err always on the conservative side; consequently the total value arrived at by them each year would probably be materially less than the figure which they would advise the shareholders as a body to accept from any party who might desire to purchase the company's business. Having expressed through the medium of the company's balance sheet their opinion as to the value of the business, the directors would find it difficult to ask, in negotiations with a prospective purchaser, some considerably higher figure.

And what would be the position of the auditors if balance sheets were prepared on such lines as these? Would they be deemed to have any responsibility in connection with the values which the directors might consider fit to place on the various fixed assets, including goodwill? If the responsibility of making an annual valuation is deemed to be an unfair burden to place upon the shoulders of the body of men who are actively administering a business, as the directors are, then, *a fortiori*, the responsibility for

criticizing that valuation would be too great to place upon the shoulders of auditors.

I need hardly refer to the evil possibilities which might arise if a board of directors were unscrupulous and allowed ulterior objects to influence the amount of the valuation.

Another point to bear in mind is that a surplus on revaluation of fixed assets with a consequent insertion of a reserve on the capital and liabilities side of the balance sheet would not have any effect upon the question of profits or of dividend. The reserve would be an unrealized capital reserve; and it is not wholly free from doubt whether such a reserve would be available for distribution in dividend. Further a shortage or deficiency shown on a revaluation of fixed assets with a consequent insertion of an item representing the loss on revaluation on the assets side of the balance sheet does not normally mean that the shortage must be written off to profit and loss account before arriving at profits which are legally available for dividend. The loss is a capital and not a revenue loss; and while from the point of view of economics it may be sound to consider that no profits can be available for dividend so long as the capital of a company is not intact, such is not the law, nor in practice may such a policy be an appropriate one. If a very profitable business was acquired for, say, £100,000 of which, say, £40,000 was represented by goodwill; and if the profits subsequently declined to a level which meant that the value of the goodwill had disappeared, the shareholders might well resent a policy on the part of the directors whereunder the whole or a large portion of the current annual profits was devoted to writing down the goodwill figure of £40,000 in the balance sheet until it was extinguished. The shareholders would contend that if it was unlikely that the goodwill so lost would be regained, the company ought to write its share capital down from £100,000 to £60,000, thus extinguishing the goodwill item in its balance sheet. They would argue, and quite soundly, that the fact that the company had lost a part of its capital did not constitute a good reason for denying them dividends on their shares so long as profits still continued to be earned.

Earning Capacity the Guide to Asset Values

This reference to profits leads me to make a few observations on profit earning capacity as a guide to the value of

a business. Speaking in general terms, the only thing that gives business assets any value is the annual profit that can be made by their use—either a present profit or an anticipated profit. The value of an asset or a group of assets at any particular time may well be a matter of opinion; but the profit earned in a particular period is largely a matter of fact. Many people are apt to pay too much attention to a company's balance sheet and too little attention to its profit and loss account. It is true that a company's balance sheet exhibits a position which is the result of transactions which have occurred during the whole of its life, whereas the profit and loss account only shows what the profits are for the last year. And it may be true also that, owing to some special circumstances, the profits of that company for that particular year are abnormally high or abnormally low and therefore afford little guide as to future probabilities. But a comparison of the results with those shown by the profit and loss accounts of preceding years, coupled with such information as is afforded by the directors' reports and the chairman's speeches at annual meetings, affords, as a general rule, a better guide to the approximate value of a business than does the balance sheet, although the balance sheet sets out the assets and the liabilities.

In this connection it is interesting to note that the form of report required to be made on a company's accounts by its auditors under the Companies Act refers only to the balance sheet and not to the profit and loss account, although it is recognized that auditors cannot thereby relieve themselves of responsibility in regard to the information disclosed by the profit and loss account, bearing in mind, *inter alia*, that the balance of the company's profit and loss account is brought into the balance sheet. Possibly when the question of revising the Companies Act comes to be considered it may be regarded as appropriate that the statutory wording demanded of auditors should include a reference to the profit and loss account.*

In connection with the existing statutory form of auditors' reports, it is perhaps unfortunate that certain words are used in regard to the balance sheet which are apt to

[*Editor's Note—The Act referred to by Mr. Cutforth is *The Companies Act, 1929* of Great Britain. Section 120(1) of *The Companies Act, 1934* (Canada) is similar to section 134(1) of the British Act, except that in the Canadian Act "shareholders" and "at any annual

mislead those who have little or no knowledge of the principles on which the figures relating to assets are embodied in books of account and consequently at which they appear in balance sheets. The auditor is required to report whether in his opinion the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs. The words to which I specially refer are "so as to exhibit a true and correct view." People have called my attention to the balance sheet of a company whose goodwill may be worth £1,000,000 but where it does not figure in the balance sheet at anything at all; and they have shown me balance sheets where goodwill appears at, say, £1,000,000 but where it has been entirely lost. In each case the auditors give an unqualified certificate—that is to say, they report that the balance sheet exhibits in their opinion a true and correct view of the state of the company's affairs. "Surely," they say to me, "there must be something wrong about that." I have explained to them that in the first case the company had built up the valuable goodwill itself and that as it had paid nothing for that goodwill it could not figure in its balance sheet; and I explained that in the second case the company had paid £1,000,000 for the goodwill which was stated on the balance sheet as being brought in "at cost," and I added that balance sheets did not pretend to be valuation statements. But, all the same, I feel that there is not a little to be said in favour of amending the statutory wording of the auditors' certificate such, for example, as by omitting the reference to a "true and correct view" and possibly inserting instead a sentence to the effect that the balance sheet is in agreement with the books and is drawn up in accordance with proper accountancy principles.

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meeting" are substituted for "members" and "in general meeting" respectively of the British Act. Section 120(1) reads as follows:

> "The auditors shall make a report to the shareholders on the accounts examined by them and on every balance sheet laid before the company at any annual meeting during their tenure of office, and the report shall state
>
> "(a) whether or not they have obtained all the information and explanations they have required; and,
>
> "(b) whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company."]

I have so far mainly harped on the question of a balance sheet's natural limitations, but not, I hope, to an extent which makes you think that a balance sheet has few uses. After all, its limitations, though important, are broadly confined to the question of the values of fixed assets; and I have endeavoured to indicate the difficulties that would be met with if in regard to fixed assets some other basis for their insertion in balance sheets were adopted. So far as floating assets are concerned, balance sheets as a general rule tell substantially all that there is to be told; and the same is true in regard to liabilities.

Disclosure of Liquid Position

One of the many important uses of a balance sheet is the disclosure of the strength or the weakness of what is commonly known as the liquid position of a business, that is to say the position in regard to its floating assets and its floating liabilities. Has the business sufficient floating capital for its presumed ordinary needs? Has it a surplus of floating capital over and above its ordinary needs which would be available to make good losses which might be sustained in some special and unforeseen circumstances or which might occur over an extended period of depression? Has the business surplus floating assets which could be utilized in meeting any capital expenditure which may be necessary for the continued extension of its activities? If it has not, then a question to be considered is that of the possible sources from which the money might be found. (I am assuming, of course, that the business is owned by a limited company and not by an individual or a firm.) Possible means of providing the money are by a bank loan or by an issue of debentures or by the issue of further share capital. A perusal of the balance sheet will disclose whether debentures or bank loans of any considerable amount already exist, and also whether these liabilities are secured on any assets of the company. Speaking in general terms, the larger the loan liabilities of a business in relation to its assets, the less favourable are the prospects of raising further money by debentures or loans in order to finance the needs of the business on capital account.

As to the question of raising the money by the issue of further share capital, the prospects of doing so on reasonable terms can be assessed by reviewing the ratio which

the profits as shown by the company's past experience bear to the existing share capital and the rates of dividend which the company has been able to pay on such capital.

Another question which can frequently be answered by the intelligent perusal of a company's annual accounts is whether the tendency of the business, as shown by a comparison of its balance sheets over a series of years, is to become stronger in regard to liquid resources or whether the tendency is in the opposite direction. Closely linked with the consideration of this matter is that of the company's dividend policy. Some companies distribute substantially the whole of their available profits each year in dividend, while other companies adopt the more conservative policy of placing a considerable proportion of the profits to reserve account. The effect of the latter policy is, of course, to increase each year the net assets of the business, thus strengthening the position. If the money thus put back —or, to use a colloquial expression common in the financial world, "ploughed back"—into the business is not required to meet expenditure on additions to fixed assets such as buildings and plant or to redeem debenture or loan indebtedness, it becomes merged in the floating capital. If the business has already sufficient floating capital for its needs the additional funds thus provided would probably be invested in stock exchange securities which would be readily realizable in the event of the business at some future date needing the money. By this means an additional bulwark is created against future adverse contingencies. Among these contingencies is that of a series of lean years when the company might sustain trading losses. Just as profits made but not distributed in dividend add to the capital in a business, so losses sustained drain capital away; many a business has had to close down owing to the floating capital, without which it could not be carried on, becoming depleted by operating losses.

Before I leave the question of floating capital I should perhaps mention that the fact that the floating assets of a business may exceed the floating liabilities does not necessarily mean that the business is adequately equipped with floating capital. And conversely, the fact that the floating liabilities of a business may exceed its floating assets does not necessarily mean that the business is short of floating

capital. Some businesses need a considerable amount of floating capital; in other words, their floating assets must always be considerably in excess of their floating liabilities. Other businesses need little or no floating capital. A fashionable West End tailor who has to pay most of his staff once a week and the remainder once a month and who has to pay for his purchases of cloth monthly, but who has to give relatively long credit to his customers, is an example of a business needing a considerable amount of floating capital. Such a man's book debts and stock of cloth at any moment would very greatly exceed his liabilities to workpeople and cloth merchants. On the other hand, the business of a coal factor may need little floating capital. The coal factor buys the coal from collieries and sells it to retail coal merchants. He arranges his buying and selling contracts in a manner which ensures that, on average, he has at the most a very small stock of coal in hand and unsold. The collieries may give him longer credit than he gives the retail coal merchants; in other words, he receives the money for the coal which he sells at an earlier date than that at which he has to pay the collieries who supply him. To put the matter in another way, his liabilities to the collieries at any moment exceed the total owing to him by the retail coal merchants.

When therefore you review a company's balance sheet with the object of forming an opinion as to whether its business is adequately equipped with floating capital, do not arrive at a conclusion by merely adding up the amounts representing the different classes of floating assets and deducting the liabilities. If a company has adequate floating resources to enable it to purchase all the stock-in-trade which it requires and to give to its customers all the credit it desires to give them, and to pay its liabilities as and when they fall due, it cannot be said to be short of necessary floating capital. Even the appearance on the balance sheet of a bank loan may not imply a shortage of *necessary* floating capital. Some businesses do a seasonal trade and their stock and book debts may be much higher at the date of the balance sheet than is the case throughout the year as a whole. Such businesses are faced with the alternative of having to maintain for a greater part of the year bank balances in excess of their needs (which earn little or no interest) or of borrowing money from their

bankers each year for a relatively short period. The second may well be the most businesslike course.

Secret Reserves

Any observations on the use, abuse and limitations of balance sheets would be incomplete without some reference to the very contentious questions surrounding what are known as secret reserves.

Some people take the view that there should be no such thing as a secret reserve; in other words, that a balance sheet should disclose the existence and the amounts of all reserves that are free. They point out that, to the extent to which a company's balance sheet does not disclose the existence of free reserves, it cannot be said to exhibit a true and correct view of the state of that company's affairs. If this view were to be accepted and acted upon, however, certain important difficulties would arise in practice. A hidden reserve may exist in the form of the overstatement of a liability or in the form of the understatement of an asset. If it exists in the first form it is represented by a credit balance in the company's books, and that credit balance is merged in the balance sheet in a general item under a composite head such as "Creditors, Specific Reserves and Reserves for Contingencies." No difficulty would arise, in such a case, of exposing the reserve as a separate item in the balance sheet if this were desired. If, however, a hidden reserve has been created by the understatement of assets, the position is not, or may not be, so simple. A company may have chosen to apply part of its profits over a series of years to write down the cost of goodwill in its balance sheet. If at any particular date the real value of the goodwill is exactly equal to the figure which the company originally paid for it, then it may be said that the amount of the hidden reserve at that date is equal to the sums which have been written off the goodwill. But supposing that the goodwill has increased in value since it was acquired, or alternatively that it has decreased in value since it was acquired, what then? The ascertainment of the amount of the hidden reserve at any particular date would, under those circumstances, involve the valuation of the goodwill at that date; and I have pointed out in an earlier part of my address what a margin there is for difference of opinion on a matter like this. Much the same

considerations arise in cases where a company has in effect created hidden reserves by writing depreciation off premises, plant and machinery on a liberal scale over a series of years. The measurement of the amount of the hidden reserve at any particular balance sheet date would involve a revision of the sums provided in respect of depreciation and obsolescence over a long series of years, or alternatively a revaluation of these fixed assets. These questions concern matters on which there may be wide differences of opinion; and who is to be made responsible for such a review and opinion?

We therefore see that while there is little or practically no difficulty in disclosing the secret reserves represented by credit balances, there would be great practical difficulties in assessing the amount of hidden reserves represented by excessive writings down of fixed assets.

To my mind the question of the non-disclosure of the amounts of secret reserves in balance sheets is less important than that of the non-disclosure of amounts transferred to secret reserves or from secret reserves through the medium of the annual profit and loss account. As I have already mentioned, net earnings constitute, as a rule, a better measure of the value of a business than do the asset value as appearing in a balance sheet; it therefore becomes specially important to consider very carefully as to whether full disclosure should not be made when, in arriving at the so-called profits of a year, sums have been secretly transferred to or from the profit and loss account from or to a hidden reserve. Obviously the question of degree must enter into the consideration of the matter: obviously, also, one would look more critically at a case where the disclosed profits had been inflated than in the case where they had been diminished by such a transfer. There will be common agreement that in cases where the amount involved is important the profit and loss account at least should indicate by the use of appropriate words what had been done, without necessarily specifying the sum. This would put the shareholders upon enquiry; and after all, the shareholders as a body can, in the last resort, enforce disclosure of the amount.

Time does not permit of my stating or discussing the arguments in favour of allowing the directors of a public company the discretion to augment and deplete free reserves

without disclosing the fact to the shareholders through the medium of the annual accounts. Nor, possibly, would such discussion be appropriate having regard to the title of my paper. But it is pertinent for me to point out the obvious fact that the existence of secret reserves in a balance sheet does add to its limitations as an informative document.

Interests in Subsidiary Companies

Closely bound up with the question of what may be called the true net earnings of a year is that of the treatment in the published accounts of a company of its interest in what are known as subsidiary companies, that is to say, companies which the parent company is in a position to control.

A parent company is not legally entitled to include in its annual profit and loss account anything more than the dividend actually received by it during the year from its holding in the subsidiary company. But as it is in a position to determine the amount of the dividend which the subsidiary company shall declare, it can in effect create hidden reserves by instructing the subsidiary companies to place to reserve or carry forward a considerable portion of their profits instead of distributing the whole or substantially the whole in dividend. The Companies Act 1929 requires a holding company to state how the profits of the subsidiary company, so far as they concern the holding company, have been dealt with, but this provision is in practice met by the statement by the holding company that it has taken credit for its share of the profits of subsidiary companies to the extent of the dividends actually declared. The Act expressly states that it is not necessary to specify the amount of the holding company's share of the profits or the amount of dividend which the holding company has received in respect of such profits.

It will be appreciated that under the above circumstances it is possible for the profit and loss account of the holding company to give a quite misleading impression of what may be called the true economic net earnings of that company. The very widely held view in the accountancy profession is that the provisions of the Act of 1929 require amendment in the direction of enforcing more disclosure in this particular respect.

The ownership by a company of the whole of, or a con-

trolling interest in, the capital of a subsidiary company not only obscures or limits the information which the holding company's profit and loss account affords; it also limits the information which the holding company's balance sheet discloses.

The holding company's balance sheet may contain among the assets an item described as "Cost of the whole of the share capital in the X.Y.Z Company," and that description is a true and correct one. But without supplementary information the shareholders in the holding company have no knowledge as to how much of this figure is represented by goodwill, how much by fixed assets such as land, buildings, plant, etc., and how much by floating assets. Legally these are, of course, the assets of the subsidiary company; but from the practical point of view they may be said to be owned by the holding company subject, of course, to the claims of any creditors in the subsidiary company. And when referring to creditors of the subsidiary company it should be noted that a subsidiary company may have heavy liabilities in the form of debentures or loans which rank in front of the share capital which the holding company owns; but no information to that effect would be afforded by the balance sheet of the holding company.

In a number of case holding companies do, in practice, furnish to their shareholders this kind of information either by publishing a consolidated balance sheet in which the various assets and liabilities of subsidiary companies (to the extent of the holding company's interest therein) are merged with those of the holding company, or by publishing separately the balance sheets of the subsidiary companies. But there are numerous instances where such information could conveniently be furnished but where it is withheld, and it may be that in due course Parliament will see fit to make some disclosure of this nature obligatory. It will not be easy, however, to frame legislation which will be effective in achieving the objects desired but which will not impose unreasonable conditions in numerous cases where somewhat special circumstances exist.

Tendency Towards More Informative Company Statements

Passing from the question of subsidiary companies and speaking in general, it may fairly be said that, taking the balance sheets and profit and loss accounts of public companies as a whole and looking back over the past, the prac-

tice of boards of directors has been to curtail information or to present it in an abbreviated form. For a number of years, however, there has been a tendency towards making these annual statements more full and informative, and this tendency has been specially noticeable during the last few years. It is much to be hoped that this movement will continue, as there is still room for considerable improvement. While legislation can be partially effective by enforcing developments on certain defined lines, still more can be achieved by shareholders and the press as the result of reasonable enquiry, comment and criticism. It is far preferable that evolution should proceed as a result of voluntary rather than compulsory measures.

Summary and Conclusion

May I in conclusion summarize very briefly the chief points which I have endeavoured to emphasize in my paper:—

(1) There is a good deal of misconception, even among business men, in regard to what a balance sheet purports to be.

(2) Balance sheets have certain natural limitations; in particular they are not valuation statements.

(3) There are certain broad principles on which balance sheets are compiled, and the reasons for the adoption of these principles are sound.

(4) If the principles upon which balance sheets are compiled were abandoned and endeavours were to be made to present balance sheets in the form of valuation statements, practical difficulties of the first magnitude would arise and the possibilities of abuse would be great.

(5) Speaking generally, annual profits afford a better indication of the total value of a business as a going concern than do the assets and liabilities appearing in the balance sheet; and balance sheets should therefore be studied in conjunction with profit and loss accounts.

(6) In spite of the limitations to which balance sheets by their very nature are subject, a review of a company's balance sheets and profit and loss accounts over a series of years furnishes information on a number of matters of vital importance, such as the nature and extent of the liabilities, the adequacy of floating resources, the growth or the decline in the earning capacity of the business, the

capacity of the business to withstand a period of depression or adversity, the policy of the board of directors in regard to the building up of reserves; and in short, the general financial strength of the company.

(7) The limitations in the information which the balance sheet of a public company discloses are certainly not lessened if the balance sheet contains hidden reserves. As, however, these reserves frequently take the form of undervaluation of fixed assets, any attempt to expose all hidden reserves would involve the valuation of such assets at the date of each balance sheet; and in this connection difficult and contentious questions would arise.

There are, however, specially strong arguments in favour of disclosing any transfers of importance to and from hidden reserves from or to the profit and loss account, as the latter account purports to show the true earnings of the year. Even if it were regarded as inexpedient in a particular case to disclose the sum so transferred, it might still be considered necessary to indicate its existence by suitable wording.

(8) The ownership by a company of a controlling interest in the share capital of a subsidiary company specially lends itself to the withhholding from the shareholders of the holding company of information as to the position of the subsidiary company both in regard to assets and profits. The legislation designed to remedy this has not proved sufficiently effective in practice.

(9) In general the balance sheets and profit and loss accounts of public companies have for many years erred on the side of disclosing the minimum rather than the maximum of information. But a tendency to disclose fuller information has been very noticeable during recent years, and it is much to be hoped that this improvement in practice will continue. It is preferable that improvement should come as the result of voluntary action rather than as the result of legislation.

I trust that I have made myself reasonably clear to those of you whose acquaintance with accountancy and financial matters is very limited; and as regards the many members of the audience whose knowledge of these subjects is much more extensive, I can only express the hope that here and there I may have exhibited some old truths in a fresh light.

RETAIL METHOD OF INVENTORY CONTROL

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IN TRADING businesses where an accurate determination of the profit earned during a period is dependent on a proper valuation of the merchandise on hand at the end of the period considerable attention must be given to methods of taking inventory. If the inventory at the end of the period is valued at too high a figure, the profit is overstated. On the other hand, if the inventory is valued at too low a figure, the profit is understated. For that reason merchants are interested in a plan of control that will help to overcome this difficulty, and at the same time furnish an accurate inventory valuation.

The retail method of inventory is the name applied to the type of inventory valuation record which is maintained by trading businesses on the basis of retail rather than cost price. Departmental stores have been the leaders in the development of the system of inventories at retail, although many other retail businesses are using it to advantage at the present time. The general aim is to know at all times the value of the inventory on hand at retail and the percentages of mark-up, mark-down, shortages and gross profit. Retail prices are used throughout, cost being introduced only for the purpose of determining the profit for a period.

Under the cost plan of inventory, merchandise on hand is commonly valued at cost or market, whichever is lower, since it is considered a conservative policy to anticipate losses but not to anticipate profits. Under the retail method, inventory is taken at the retail price of the merchandise in stock, rather than at the cost or market value, and reduced to balance sheet value.

The method of computing the inventory under the retail plan is as follows: The inventory at the beginning of a period is entered on a sheet (Exhibit I) at both cost and retail figures. All purchases during the period likewise are entered at both cost and retail, freight, express and cartage-in being added to the cost. Adjustment is made to take care of additional mark-ups and additional mark-up cancellations. Thus there are available total cost figures and total

retail figures for all goods handled during the period. The difference between the cost and retail figures is the amount of mark-up. This is computed as a percentage of the total retail figure. From the total retail figure is subtracted net sales for the period, plus mark-downs, less mark-down cancellations. The balance is a book figure for the retail value of merchandise that should be on hand. A physical inventory is taken at the retail figures appearing on the merchandise. Any discrepancy between the retail book inventory and the actual physical inventory is a retail stock shortage, or overage as the case may be. To the actual retail inventory figure is applied the complement of the percentage of mark-up, in order to ascertain the cost or market value of the closing inventory.

From the point of view of the balance sheet the correctness of the valuation of the inventory will depend upon the correctness of the percentage of mark-up, since that is the percentage which is used to reduce the inventory from retail to balance-sheet value.

The following case will serve to illustrate the method.

EXHIBIT I

Form for Computing Inventory According to the Retail Method

Merchandise	(1) *Cost*	(2) *Retail*	(3) *Mark-up*	*Per cent. of mark-up to retail*
1. Opening inventory (lines 9 and 10 of preceding period)	...	...	...	...
2. Purchases	...	...	...	...
3. Freight, express and cartage, inward	...	000	000	000
4. Additional mark-up, less additional mark-up cancellations .	000	...	000	000
5. Total inventory, plus additions	...	...	...	...
6. Net sales	000	...	000	000
7. Mark-downs, less mark-down cancellations	000	...	000	000
8. Total retail deduction (sum of items 6 and 7)	000	...	000	000
9. Resultant retail inventory (retail inventory on line 5, column 2, minus item 8)	000	...	000	000

10. Calculation of cost percentage:
(a) Total percentage 100%
(b) Percentage of mark-up (line 5, Col. 4) ...... %

(c) Percentage of Cost (a) minus (b) ...... %

11. Cost inventory (item 10 (c) applied to item 9)	...	000	000	000
12. Resultant mark-up and percentage (item 9, minus item 11)	000	000	...	...
13. Gross cost of merchandise sold (difference between cost inventories on lines 5 and 11)	...	000	000	000

The men's furnishing department of the Worcester Company, a large departmental store, had in stock on 1st September 1936, according to a physical inventory, merchandise valued at $27,592, at net cost, and $44,301, at retail prices. During the month of September, purchases at net cost for this department amounted to $11,582.

The goods purchased during September were marked to sell at retail for $18,898. During September, gross sales amounted to $17,411, customers' returns were $1,319, discounts to employees $167, and mark-downs $1,132. The net cost of merchandise sold during the month, as recorded from sales slips, amounted to $10,095. Expenses during September were as follows:

Salaries of salespeople	$1,873
Salary of buyer	315
Advertising	445
Supplies and other direct selling expenses	80
Delivery	438
Rent	620
Prorated share of general expenses	1,710
	$5,481

On the cost basis the gross margin is $5,997, the difference between net sales of $16,092, and cost of merchandise sold (as determined from a cost audit of sales slips) of $10,095. Subtracting the total expenses of $5,481, from this gross margin leaves a net profit of $516.

On the retail basis the cost value of the inventory is determined as $28,394.09, the result of applying the cost complement, 61.985% (100% — 38.015%), to the retail book inventory of $45,808, and thus the cost of merchandise sold on this basis is $10,779.91, the gross margin is $5,312.09, and the net loss $168.91.

Cost Basis

Sales	$17,411
Less returns	1,319
Net sales	16,092
Cost of goods sold	10,095
Gross margin	5,997
Expenses	5,481
Net profit	$ 516

Retail Basis

	Cost	*Retail*	*Mark-up*	*Per cent.*
Inventory	$27,592	$44,301		
Purchases	11,582	18,898		
Total	39,174	63,199	$24,025	38.015%
Sales	$16,092			
Discounts	167			
Mark-downs	1,132			
	$17,391			
Resultant retail inventory	$45,808			
	61.985% (100% — 38.015%)			
Cost inventory	$28,394.09			

Profit and Loss Statement under Retail Basis

Sales		$17,411.00
Less returns		1,319.00
Net sales		16,092.00
Deduct—Cost of sales:		
Inventory	$27,592.00	
Purchases	11,582.00	
	39,174.00	
Less Inventory	28,394.09	10,779.91
Gross margin		5,312.09
Expenses		5,481.00
Net loss		$ 168.91

The principal reason for the discrepancy between the two profit figures lies in the fact that the cost method does not take into account the effect of mark-downs on goods still unsold, whereas the retail method immediately registers the effect of a mark-down, showing it as a loss in the period in which the mark-down is taken, without the necessity of waiting for a physical inventory.

Mark-Downs

Mark-downs are not considered in arriving at the average percentage of mark-up. They are not allowed to reduce the original percentage determined at the time the goods are first marked. The reason for this may be shown by the following illustration. If an article were purchased for $100 and marked to sell for $150 the average percentage of mark-up would be 33⅓ per cent. If this article remained unsold and were inventoried at the end of the period, a deduction of this 33⅓ per cent. from the $150 would

result in a return to the cost of $100. Assume, however, that the buyer subsequently marked the price of the article down to $140 and that the article still remained on hand at inventory time. If a new percentage were to be arrived at, it would be 28 4/7 per cent. which, when deducted from the $140 retail price, would bring the value back to the original cost of $100. If, however, the 33⅓ per cent. were left unaffected by the mark-down, and that percentage were deducted from the new price of $140 this would result in a value of $93.34. Thus it can be seen that changing the percentage does not reduce the retail price below cost, while deducting the original percentage would reduce it. Since it was necessary to reduce the sales price, the assumption is that the value has decreased below the cost of $100. According to sound accounting, inventories should be valued at cost or market, whichever is lower. Under the retail method in order to bring the value of marked-down goods below cost, the percentages are not reduced as a result of mark-downs. In this illustration 33⅓ per cent. would be deducted from the $140 and the value of $93.34 would be used.

Mark-Ups

In order not to bring the value above cost in cases where there are additional mark-ups, such additions should be brought into account in determining the percentages of mark-up. To use the preceding illustration: if the $100 article which had been marked to sell at $150 were increased in price to $160 and the original 33⅓ per cent. were deducted from the new retail price, it would result in an inventory value of $106.67, which would be $6.67 above cost. This would mean the taking of an unrealized profit. If, however, the amount of the mark-up were included in the figures from which the percentage is arrived at, a new percentage, 37½ per cent. would result, and this, when deducted from the $160 selling price, would give a value of $100, which is cost. Thus, under the retail method, by excluding mark-downs from the percentage of mark-up, and by including mark-ups in the percentage, inventories will be valued automatically at approximately cost or market, whichever is lower.

Care should be taken to distinguish between mark-ups and cancellations of mark-downs. When goods are marked

down for a sale and the original retail price is subsequently restored on the unsold merchandise, this increase is not a mark-up, but a cancellation of the original mark-down. It should be treated as such, otherwise the inventory figures at retail reduced to value will be overstated. (See line 7 of Exhibit I)

Shortages

Probably the most common reason for large shortages is the lack of a proper method of recording price revisions both up and down.

Inventory shortages sometimes arise through buyers doing their own marking of merchandise and showing retail prices on the bills different from those marked on the merchandise. Very often, in such cases, the prices marked on the merchandise are higher than those shown on the bills, so that the buyers may have ample margin for taking mark-downs which need not be reported.

It will, of course, never be possible to do away with shortages entirely, since the theft element is present, but it is possible to minimize them. The company operating under the retail method of control has a frequent check on inventory and thus has a tremendous advantage over a company that operates without the retail method.

Advantages of the Retail Method

In companies that have used the retail method of inventory for several years, the opinion commonly is expressed that this plan affords several advantages in the actual taking of inventory, as follows: first, it is easier to take stock at retail because cost figures are usually in code; second, inventory may be taken in periods of slack business or when stocks are low, the actual physical inventory being merely a check on the book figures; third, the time necessary to take a complete inventory is reduced.

More important, however, is the advantage afforded in obtaining a proper valuation of goods or merchandise, especially when market value is lower than cost. Income tax regulations do not permit the use of arbitrary methods of depreciation. It is not possible for a company to take inventory at cost and then reduce the valuation ten per cent. to allow for depreciation. Unless the inventory is to be valued at cost, a firm using the cost or market method is

expected to appraise the market value of each item of merchandise. Even under favourable circumstances such an appraisal is an arduous task where thousands of different articles are carried in stock. Market value frequently is difficult to ascertain, and does not always represent the real value of the merchandise to the company. Where goods are carried over from the spring to the fall season, it is by no means easy to ascertain market value if the stock-taking comes at a time when similar goods are not being offered by manufacturers or wholesalers.

Under the retail method of inventory, depreciation to a fair market valuation is practically automatic, provided proper retail mark-downs have been taken. The actual inventory is taken at selling prices; the aggregate of these selling prices fairly represents what the merchant can expect to secure for the merchandise he has in stock. The deduction from this figure of the amount of mark-up gives a figure that represents the real value of the merchandise to the firm. If proper retail mark-downs have been taken, a correctly depreciated cost figure is obtained. On a constant or rising market, the retail method of inventory values the merchandise approximately at cost, but on a falling market it ordinarily results in a valuation at cost or market, whichever is lower.

A number of advantages which are peculiar to the departmental store may be summarized briefly.

1. Not only is information for each department available as to sales and purchases periodically, but also as to the inventory, the mark-downs, and the percentages of mark-up. Having this information, the merchant is in a position to control his business more closely.

2. Comparisons from season to season and from year to year are more easily made.

3. If the store operates a merchandise budget, that is, planned sales, inventories and purchases, the retail method is of great importance in giving, at frequent intervals, accurate data of the stocks on hand with which to gauge purchases. Without the retail method, the determination of the periodic inventories must be based on average percentages of gross profit for long periods. These percentages, while perhaps accurate for long periods, are totally inaccurate for short periods, particularly in style departments

in which frequent sales are conducted, since in such cases the percentages of gross profit at the height of the season are considerably higher than the average, and the deduction from sales of the average percentages gives an inflated view of the inventory.

Arguments Against the Retail Method

Lack of appreciation of the above advantages has been the greatest factor in deterring companies from adopting the retail method.

A complaint sometimes heard is that the retail method does not give accurate results in departments that handle several classes of merchandise, some of which are sold at high and others at low percentages of gross profit. For illustration: the merchandise of one department may consist of two or more large classes with varying percentages of mark-up. Unless the sales for the various classes are in proportion to the purchases, the inventory valuation may be either too high or too low.

	Class A Merchandise		*Class B Merchandise*	
	Cost	*Selling*	*Cost*	*Selling*
Purchases	$10,000	$15,000	$10,000	$20,000
Sales	8,000	12,000	1,000	2,000
	2,000	3,000	9,000	18,000
Mark-up	33 1/3%		50%	

The combined figures calculated by the retail inventory method would give the following:

	Cost	*Retail*	*Mark-up*
Purchases	$20,000	$35,000	42 6/7%
Sales		14,000	
Retail inventory		$21,000	
Cost Inventory (100% — 42 6/7%) is 57 1/7%, or		$12,000	

The actual inventory, however, is $11,000, consisting of $2,000 Class A merchandise and $9,000 Class B merchandise. Where such a condition exists the solution is to divide the department into units, keeping separate stock figures for each unit.

Other executives have stated that the percentages of mark-up arrived at from the retail inventory records are not accurate when tested against actual pricings of the individual items of the inventory. It will usually be found, however, if the pricing of the individual items has been properly done, that those that have made this test do

not arrive at the percentage of mark-up properly; they usually include mark-downs and sometimes even the shortages in arriving at the percentages. The average percentage for a department for a period of years varies little, and a fair test will show that the cost method and retail method will give approximately the same results.

There is a feeling that the retail method gives misleading results because mark-downs are taken and not reported. This is not the fault of the system but rather a fault in carrying it out.

Complaint has been made that when special sales are planned to be held several months after inventory date, the reduced value can not be taken up under the retail method since it is not wise to mark the retail prices down immediately. Under the old cost method the retail price could be left unchanged whereas the cost was reduced. It should be remembered, however, that while the reduction can not be put through until the goods are actually reduced, there is no inhibition against setting up an inventory reserve on the general ledger for mark-downs of this character. This does not interfere with the retail method of inventory control.

The best results from the retail method of inventory control are likely to be secured by well departmentalized businesses. It was developed as a result of the necessity for periodic inventory. For the proper management of any merchandising business, it is desirable to have available at all times figures showing the amount of merchandise on hand. The value of this merchandise must be known in order to determine the profit. In a well managed business there should be some way of determining periodically the profit that is being made without resorting to an actual physical inventory. The use of the Retail Method of Inventory Control will solve this difficulty. A physical inventory, nevertheless, should be taken periodically as a check on the retail book inventory. In principle the method is simple; in practice it must be operated very carefully, else unreliable results will be secured.

THE CANADIAN WHEAT POOLS: 1929-1936

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DURING the past six years public attention has been focussed continually on the wheat problem, and a considerable volume of literature has appeared on various aspects of our wheat marketing policy. In view of the dominant position which this great staple holds in our economic life, the catastrophic fall in world wheat prices after 1929 and the concomitant surge of agricultural protectionism in Europe had serious repercussions not only on wheat growers themselves but on the whole economy. The government, which had hitherto merely laid down through regulatory legislation a sort of framework within which the grain trade could function, now found itself forced to give active assistance to wheat growers—in the shape of special bonuses and direct relief—and, for the first time since the War years, to interfere with the free functioning of the open market by authorizing in the summer of 1931 an individual to make purchases, under its guarantee, of wheat which speculators were unwilling to take. This "stabilization" policy, supplemented later by price pegging, had the effect of accumulating some 228,000,000 bushels of futures and cash wheat under government guarantee, consequently involving the government in a huge contingent liability. Marketing policy was subsequently reversed by the establishment of the Canadian Wheat Board in August 1935, and to date our policy has been one of disposing of these accumulated surpluses, an action which has been made possible largely through a succession of short world crops.

The purpose of this paper is not to discuss our wheat marketing policy since 1929, but rather to focus attention on the position of the Wheat Pools since that date. Due to the overwhelming importance attached to the operations of Mr. McFarland and those of the Wheat Board, interest in the pools and their policies has lagged somewhat. In this paper I propose to sketch briefly their history since 1929, and to lay special emphasis on the reorganization they have undergone, their operating results and their present status.

The Pools in 1928

The earlier history of the pools has been treated so admirably elsewhere that it would be otiose even to touch on it here.[1] Suffice it to say that by 1928 the three Pools and their Central Selling Agency had reached the peak of their power. In that year they controlled fully one-fifth of all wheat entering into international trade, their membership of 133,000 farmers constituted approximately one-half of the farmers in Western Canada, and their chain of 1,642 country elevators was one-third of all country elevators in Western Canada. This huge elevator system (including twelve terminal elevators owned or operated by lease) constituted an investment of some $25,000,000, had been acquired without recourse to government loans or bond issues, and had been paid for in cash.[2] This had been accomplished partly by elevator reserve deductions of two cents a bushel from the annual sales returns of each member, and partly by 1% commercial reserve deductions. Members were credited with interest at 6% on these deductions, and surplus elevator earnings were returned to them on a patronage basis.

The distinguishing characteristic of the pool was that (except for a small percentage of its business) it did not sell on the Winnipeg market but sold direct to millers and merchants at home and abroad without recourse to hedging. Members were given an initial payment at the time of delivery and, during the course of the year as the wheat was gradually disposed of, interim and final payments. This practice laid the pool open to the danger of adverse price movements which conceivably could carry the price of wheat below the initial payment disbursed and, coupled with the absence of hedging, place the pool in serious financial difficulties. This latent danger was made all the more real by the fact that the assets of the pool were not sufficiently liquid to meet such a contingency. Up to 1928 this possibility had not arisen and, moreover, it was generally felt that the pool's influence as a stabilizing agency could to some extent prevent its occurrence, although the more cau-

[1]Especially H. S. Patton: *Grain Growers' Co-operation in Western Canada* (Harvard Economic Studies, Vol. 32, Cambridge, Mass. 1928).

[2]Except for $8,500,000 of instalment obligations assumed in the purchase of the Saskatchewan Co-operative Elevator Co.

tious of pool members must have realized its limitations in this respect.[3]

Obstacles Develop

Indications of the approaching *débâcle* made their appearance in the crop year 1928-29 which, although a highly successful one for the pool, nevertheless involved considerable difficulties in marketing due to the vigorous competition of Argentina. This country, peculiarly dependent on an inward flow of capital to balance its international accounts, found the raising of loans an increasingly difficult matter about the middle of 1928, and this, coupled with a bumper wheat crop and inadequate storage facilities, forced it to press its crop on the market. This pressure was so great that for the second time in its history the pool was forced in May 1929 to enter the market to support the price, buying some four to five million bushels.[4] On 31st August 1929 the pool found itself with the large carry-over of 48,358,585 bushels.[5] It was thus unable to declare a final payment on the 1928-29 deliveries.

With the opening of the 1929-30 crop year the pool made the serious error of setting its initial payment at $1.00. The price of wheat at the time was about $1.50, and prospects in general looked favourable in view of anticipated short world crops. Trouble started almost immediately, with the price of wheat beginning to sag. As in previous years, the pool had financed its initial payment with credit obtained under Section 86 of the Bank Act, the banks stipulating a margin of fifteen per cent. between the value of the grain used as security and the amount of credit.[6] Loans of some $69,000,000 on account of the unsold 48,000,000 bushels of the 1928-29 crop were carried over by the banks.

With prices sliding rapidly, by February 1930 the fifteen per cent. margin had become endangered and, unless some

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[3]On the limitations of the market influence of the Pool see Patton: *The Market Influence of the Canadian Wheat Pool.* (Proceedings of the American Statistical Association 1929).

[4]Address of A. J. MacPhail before the Regina Board of Trade, March 13, 1930.

[5]Directors' Report, Canadian Co-operative Wheat Producers Limited, 1928-29.

[6]The pools dealt with seven banks: Bank of Montreal, Royal Bank, Canadian Bank of Commerce, Bank of Nova Scotia, Imperial Bank, Bank of Toronto and Dominion Bank.

financial aid were forthcoming, it was obvious that the pool stocks would be forced on to the market. Such an action would have had serious repercussions on the whole economy, and it was prevented by the timely action of the governments of the three prairie provinces, each of which guaranteed the banks against loss on account of loans advanced to its respective pool, including the unpaid balance advanced on the 1928 crop, and such further loans as might be made up to 1st August 1930. It was a condition of these guarantees that the banks would not cause to be sold any of the pool grain before 1st November 1930.[7] The banks have at all times contended that this action was not forced by them, but that the pools got the assistance of the governments on their own initiative.[8]

The Pool as a Stabilizing Agency

I do not propose to delve into the vigorous controversy which still rages as to whether or not the pool pursued a "holding" policy in the autumn and winter months of 1929-30. That some such policy existed cannot be denied, but it is unfair to attribute it entirely to the pool. There is every evidence that the private trade was equally responsible for the retarded export movement. So impartial an authority as the Food Research Institute of Stanford University has concurred in this belief.[9] Both the pool and the private trade shared bullish sentiments in overestimating Europe's needs and in thinking that Canadian wheat was indispensable to European millers. Consequently they held back in the hope and belief that after the turn of the year Europe would be forced to come to them. As events turned out, Europe found Argentine supplies ample and more attractively priced and bought relatively little from Canada.

Granted that Canada could have followed a more aggressive sales policy would such have been desirable? There is every reason to believe that it would have led to a vicious price war with Argentina, with disastrous consequences to Canada. So authoritative an observer as Dr. D. A.

[7]Statutes of Manitoba 1930, Chap. 18; Statutes of Saskatchewan 1930, Chap. 90; Statutes of Alberta 1930, Chap. 27.

[8]Evidence of S. H. Logan: Banking and Commerce Committee 1934, p. 262.

[9]It states: "it is clear that for the year 1929-1930 as a whole, the pool cannot be alleged to have taken less than its share of Canadian sales of wheat." (*Wheat Studies*, Vol. VII, No. 2, p. 143).

MacGibbon has stated: "Wheat in Canada enters so intimately into the agricultural, mercantile and financial life of the country that had it registered a spectacular decline in value in the autumn of 1929 exceeding that suffered by share capital, the combined effects would certainly have produced an unexampled crisis in Canadian business affairs . . . . . As a method of limiting losses to the country at large the price-reduction resistance policy of 1929 is susceptible to some defence . . . . . it is doubtful . . . . . whether a policy of forcing wheat sales by unexampled price-cutting would have better served the interests of the country as a whole."[10]

The events of 1929-30 clearly revealed the weakness of the pool as a stabilizing agency. "The pooling system has proved its worth," says Dr. W. A. Mackintosh, "in meeting day-to-day, seasonal or inter-market fluctuations; with cyclical fluctuations it cannot cope."[11] On 31st August the pool found itself with an unsold carry-over of over 43,000,000 bushels, of which 3,290,000 bushels were of the 1928-29 crop.[12]

The pools entered the 1930-31 crop year in an extremely vulnerable position. They had pledged their elevator properties to their respective governments as security against losses which the latter might incur under the guarantees given the banks, and already it was evident that a loss had been sustained. Increasing wheat surpluses, falling wheat prices, deepening depression and growing dissension within the pool ranks all made it evident that the pooling system was facing its final test. The three provincial governments refused to give further guarantees, and the pool was forced to get a line of credit on as best terms as possible, this time the banks stipulating a twenty per cent. margin.[13] An initial payment of seventy cents, basis No. 1 Northern, Fort William, announced in July, was lowered to sixty cents on 25th August, and as prices continued to fall, was finally

[10]MacGibbon, *The Canadian Grain Trade* (MacMillan Co.) pp. 424-25.

[11]*Economic Problems of the Prairie Provinces* (MacMillan Co. 1935) p. 54.

[12]Directors' Report, Canadian Co-operative Wheat Producers Limited, 1929-1930.

[13]Minutes of Evidence and Proceedings, Banking and Commerce Committee, 1934, p. 262.

scaled down to fifty cents by 9th November. The margin of twenty per cent. became endangered, and a forced liquidation of pool stocks again appeared in prospect. This time federal government aid was enlisted, and the Dominion cabinet agreed to guarantee the banks against loss until the return of Mr. Bennett, who at that time was attending the Imperial Conference in London. It was also understood that the pool would instal as soon as possible a general manager acceptable to the banks. Mr. John I. McFarland was appointed to the position and one of his first acts, on 8th December, was to announce that the pool was going out of the direct export business and that all pool agencies and connections abroad were to be closed and overseas representatives withdrawn. Henceforth the pool was to operate exclusively on the Winnipeg market, hedging as the ordinary grain companies do. This action was met with widespread approval by the private trade, but was a heavy blow to the pool.

On Mr. Bennett's return at the close of the year, the guarantee of the federal government was extended to cover the 1930-31 operations of the pool. Mr. Bennett gave this guarantee officially to the banks in a letter written by him to the Canadian Bankers' Association in January 1931.[14] It was later implemented by an order-in-council which made provision for a further guarantee of such loans as might be made to purchase wheat deemed necessary "to secure the advantageous sale of such grains already delivered or to be delivered" to the Central Selling Agency.[15] This laid the basis for the subsequent "stabilization" operations conducted by the agency under Mr. McFarland.

The Reorganization of the Pools

It was clear that the pools were heading for some form of reorganization, inasmuch as the central selling agency was no longer following a direct sales policy, the pool elevators were pledged to the three Western governments, and a loss was already sustained on account of the 1929 overpayment. Moreover the pools were almost entirely without working capital. With the opening of the 1931-32 crop year action was forced. After a series of meetings between the pools, the banks and the federal government, Mr. Ben-

[14]Proceedings, Banking and Commerce Committee 1934. page 263.
[15]P.C. 2238, September 12th, 1931.

nett announced on 7th August that pool members were to be released from their five-year contracts to deliver all wheat to the pools, and were to be given the right to sell on the open market if they so wished. The three pools were to reorganize as ordinary elevator companies, operating on the open market as other firms do. The central selling agency was to become a mere agency to liquidate the unsold pool stocks. The government was to guarantee bank loans to the pools to enable them to get sufficient working capital to carry on. An initial payment of thirty-five cents a bushel, basis No. 1 Northern, was announced for those wishing to pool their wheat for the coming year.[16] There was to be no pool for coarse grains. On 31st July 1931 the three pools ceased delivering wheat to the central selling agency, and from then on each was to go its own way.

In short, the pooling system was effectively dismembered of its distinguishing characteristics, and an organization which a few years previously had been the biggest business in Canada was now to become merely three separate co-operative elevator companies. Co-operation was reverted to its pre-1924 status.

With the subsequent history of the central selling agency we are not concerned. Under the control of Mr. McFarland it became a "stabilization" agency operating under government guarantee. By June 1931 Mr. McFarland had disposed of the small remnant of the 1928 crop and the remainder of the unsold 1929 pool stocks. The exact liability of the three governments to the banks (and consequently of the pools to the governments) could now be determined. Of the 1928 stocks a small surplus was realized which would have normally amounted to a final payment of 1⅛ cents a bushel, but inasmuch as the 1929 overpayment turned out to be so large this small surplus was applied against it in determining the final liability of each pool. The exact liability with accrued interest as at 30th September 1931 was: Manitoba $3,491,000; Saskatchewan $13,752,000; Alberta $5,649,000. The three governments deposited debentures with the banks to cover their liability, these being issued at a discount of 2% and the rate of interest being 4½%.

[16]"Pooling" now was not to mean a direct sales policy, but a policy of spreading the sales of the pooled wheat over the course of the year (on the Winnipeg market) so as to realize an average price for the year.

The first pressing need of the three pools was to get sufficient working capital to carry on, and this was obtained from the banks under federal guarantee. By a series of orders-in-council the Dominion government fixed the maximum amounts which it would so guarantee as follows: Manitoba pool $1,250,000; Saskatchewan pool $12,000,000; Alberta pool $7,500,000.[17]

The Manitoba Pool

Let us now turn to the actual situation in the case of each pool, and the readjustments effected. The Manitoba pool system was in the worst financial condition of the three. Its assets, pledged to the Manitoba government, were less than the amount of its liability to it on account of the 1929 overpayment. Manitoba Pool Elevators Limited, the subsidiary of the Manitoba pool, was not a single unified elevator system, but a federation of some 150 local associations, each a separately incorporated unit, and each operating an elevator for its members. Manitoba Pool Elevators Limited had either constructed or acquired these elevators and had leased them to the various associations, the intention being that they would become their property after ten years when the purchase price would be paid off. Thus when the pool pledged its assets to the Manitoba government in February 1930, the assets in question were the annual payments to the system from each of the 150 associations. Many of these elevators had been expensively built, and at points unwarranted by the volume of deliveries in that district. Many of them were unable to carry on under existing arrangements. The Manitoba government, following a report of a Royal Commission on the matter, decided to write down part of the system's indebtedness to it, so as to enable it to continue to operate on a business basis. After a series of meetings between the local associations, the Manitoba government, the Manitoba pool and Manitoba Pool Elevators Limited, an agreement, subsequently called the Four-Party Agreement, was drawn up.

As I have shown, the Manitoba pool owed the Manitoba government some $3,374,000 on account of the 1929 overpayment. The assets pledged to the government consisted in the payments yet to be made to the system by the local associations, and these at the time of the agreement

[17] P.C. 2239; P.C. 2403; P.C. 2977.

amounted to $2,400,00. Under the four-party agreement the government agreed to reduce the pool indebtedness to it not only to this figure but to the lower figure of $2,100,000. That is, the government agreed to accept a loss of some $1,300,000. It was further agreed that the associations would be given twenty instead of ten years in which to pay off the purchase price of their respective elevators and that the rate of interest would be lowered from 7% to 5%. Manitoba Pool Elevators Limited became reorganized under the agreement. It was to issue enough capital stock to bring its total stock up to 2,800,000 shares, and it was to divide 700,000 of these among the local associations so that each would hold shares up to the amount paid so far by it in payment for its elevator. The remainder of 2,100,000 shares (equivalent to the $2,100,000 yet to be paid, and also the sum due the government on the overpayment) was to be transferred to the government. From year to year as payments are made by the various associations on account of the purchase price of their elevators, the government will transfer shares to them in proportion to the amount of their payments. Thus when the payments are completed, not only will the system's indebtedness to the government have been paid in full but the associations will also be in full control of the capital stock and be the complete owners of their elevators.

The agreement was submitted to the associations in 1931 at their annual meetings and, with one exception, was approved by all. The Manitoba pool itself was now devoid of funds and an organization without a purpose, now that the direct selling policy was abandoned and the Manitoba Pool Elevators Limited had become the central organization. On 27th June 1932 application was filed by the Gillespie Grain Company to have it declared bankrupt. On November 5th a winding-up order was issued by the court.

A supplementary agreement drawn up between the local associations and Manitoba Pool Elevators Limited in December 1932 introduced further changes in organization. The unit method of operation previously in existence was abandoned for a system of pooling resources. It was provided that the revenues of the various associations and of Manitoba Pool Elevators Limited would be pooled to constitute one general fund to be used to pay principal and interest to the government as provided for under the four-

party agreement. Any balance was to be used as working capital or reserves. This agreement has brought a considerable degree of financial solidarity and security. It was approved by all except four of the associations, which chose to operate outside its scope.

The Saskatchewan Pool

The Saskatchewan pool system was in a stronger financial situation when the crisis came. Its assets valued at \$17,455,190.64 and pledged to the Saskatchewan government on account of the 1929 overpayment were in excess of its liability, which, as we have seen, was \$13,752,000. This obviated the necessity of any writing down of indebtedness, such as characterized the Manitoba adjustment. To liquidate its indebtedness the pool transferred to the government \$13,752,000 in the form of 5% bonds on a 20-year amortization basis. This payment of obligations is to be met out of the annual earnings of the elevator system; and special arrangements have been made with individuals, who were overpaid on the 1929 crop, to enable them to work off their liability to the pool.

The Alberta Pool

The Alberta pool was in the strongest financial position of the three. Its assets valued at \$9,229,484 were in excess of its liabilities which were \$5,649,000. Besides, of the three pools, it was the only one that had any cash on hand, this amounting to some \$2,000,000.[18] As in the case of the Saskatchewan pool it issued 5% bonds to the Alberta government on a 20-year amortization basis, at a price of 98. Since the spring of 1933 there has been a slight variation in the manner of payment, the government agreeing to accept from the pool its own bonds of the issue maturing 1951 in payment of the liability. Thus since that date the pool has been buying 1951 bonds at a considerable discount under 98 and turning them over to the government.

Mention was made above that on the 1928 pool there had been a small surplus amounting to 1⅛ cents a bushel. This had been applied against the 1929 overpayment in determining the final liability. Now those members who had participated in the 1928 but not in the 1929 pool clearly deserved to get what rightfully belonged to them on account

[18] *The Financial Post* (Toronto), Nov. 14, 1931, p. 10.

of the 1928 pool. The same applied to those who had participated in both pools but whose surplus due them on the 1928 pool exceeded their overpayment on the 1929 pool. The three pools made these payments to the members concerned, the Manitoba and Saskatchewan pools getting the requisite funds with government assistance and the Alberta pool from its own resources.[19]

It can be seen that the ability of the three pools to meet their contractual obligations to their respective governments depends on the earning capacity of their elevator systems. These, formerly auxiliaries of the pooling system, are now the essential features of the pools.

Although, as already stated, the pools released their members from their five-year contracts, nevertheless they appealed strongly to their sense of loyalty and co-operation, and the great majority have responded by putting their grain through pool elevators and using the pool sales departments. The pools have also made a strong bid for non-member patronage as well.

It has already been mentioned that in 1931-32 the federal government guaranteed the banks against loss on loans which they had advanced to the pools for working capital purposes. These guarantees resulted in no loss to the Dominion government. In 1932-33 federal guarantees were again invoked to enable the pools to complete their financing. The necessary guarantees, authorized by order-in-council (P.C. 2077 of September 20, 1932) set maximum limits as follows: Manitoba pool $1,395,000; Saskatchewan pool $15,000,000; and Alberta pool $9,000,000. As in 1931-32 the government sustained no loss, the loans from the banks being repaid in full. In his budget speech of 18th April 1934 the Hon. E. N. Rhodes was able to report that for the 1933-34 crop year no further guarantees were needed since the pools were able to get the necessary credit without further guarantees in view of their improved financial condition.[20]

Results of Pool Operations

When the pools were reorganized into elevator companies, their members were given the option, as has been

[19]Statutes of Manitoba 1932, Chap. 52; Statutes of Saskatchewan 1932, Chap. 77.

[20]House of Commons Debates 1934, p. 2288.

noted, of selling their wheat on the open market or delivering it to voluntary pools set up by the three organizations.[21] Very few farmers, however, have availed themselves of the pooling facilities, and practically all the wheat passing through the pool elevators has been sold at once on the open market. The reason is that with prices as low as they were, the average farmer could not afford to wait for interim and final payments. He needed cash at once. The only farmers who have pooled their wheat are those who have had the necessary financial resources to wait.[22]

In the following tables are presented the receipts of grain by the three pool elevator systems (as well as the grain handled by them over the platform), the percentage which such bears to the total amount so delivered and handled in each province, and the amount of wheat pooled by each organization.[23]

TABLE I
(in bushels)

	MANITOBA		SASKATCHEWAN		ALBERTA	
	Volume	*%*	*Volume*	*%*	*Volume*	*%*
1930-1 ..	20,146,851	27	85,966,655	41.5	36,532,841	22.5
1931-2 ..	8,695,282	25.5	56,671,868	40.5	41,591,781	26.5
1932-3 ..	13,816,534	28.3	91,370,045	43	48,390,660	28
1933-4 ..	10,034,359	26.9	60,367,631	43.5	27,090,444	26.6
1934-5 ..	10,908,637	25.4	55,138,030	44.4	30,977,232	27.3
1935-6 ..	9,063,021	27.5	65,296,264	45.3	27,109,040	

TABLE II
(in bushels)

	MANITOBA	SASKATCHEWAN	ALBERTA
	Volume Pooled	*Volume Pooled*	*Volume Pooled*
1931-2	109,313	1,082,054	1,837,810
1932-3	615,970	6,504,169	5,461,569
1933-4	98,276	1,298,447	353,000
1934-5	101,680	1,639,265	703,767

From Table I it can be seen that the percentages are fairly steady in all cases; in general, however, tending upwards. The percentage in all cases is in consonance with the percentage which the storage capacity of each system

[21] With the establishment of the Canadian Wheat Board in August 1935 the voluntary pool system was abandoned, inasmuch as the board itself offered the necessary facilities for those desiring to pool their wheat.

[22] Minutes of Evidence and Proceedings, Committee on Grain Board Act 1935, p. 260.

[23] These figures have been compiled from the annual reports of the three pools.

bears to the total storage capacity in each province. From Table II it can be seen that in the years when the voluntary pools were in operation the total volume of wheat pooled was relatively small.

The financial results of the operations during the past few years are of more interest. The record in all cases has been a conspicuously successful one. The three systems to date have met in full their annual obligations to their respective governments on account of the 1929 overpayment. Loans obtained under federal guarantee in 1931-32 and 1932-33 have, as we have seen, been repaid in full without resulting loss to the government. The elevator systems have all shown substantial earnings, sufficient to meet all obligations, operating expenses and depreciation. Excess earnings have gone to build up working capital and reserves.

The following tables show in brief the financial results of the pool operations.

TABLE III

MANITOBA POOL ELEVATORS LIMITED

	Net Operating Surplus Of Local Associations	*Contributions To Working Capital*
1932-3	$300,634.66	$ 55,489.86
1933-4	361,046.22	103,876.78
1934-5	308,524.15	47,308.21
1935-6	293,271.96	46,461.27

The 1931-32 results are not listed for the reason that in that year the local associations operated separately, and earnings were not pooled as they have been since the "supplementary agreement." From the net operating surplus were paid principal and interest to the Manitoba government as provided for by the four-party agreement, contributions to the special reserve fund, interest on growers' equities, etc.

TABLE IV

ALBERTA POOL LIMITED

	Operating Earnings of Elevators	*Net Earnings* (Net Surplus)
1931-2	$1,123,282.40	$375,738.63
1932-3	997,948.68	179,054.64
1933-4	877,517.17	78,029.64
1934-5	746,084.62	47,788.40 (deficit)[24]
1935-6	1,092,272.59	309,513.78

[24]The 1934-5 deficit appears to have been due to very poor crop conditions in large areas of the province where the pool operated elevators. (Annual Report of the Alberta Wheat Pool 1934-5, p. 6).

From the figure in the first column provision was made for the payment of principal and interest to the Alberta government on account of the 1929 overpayment, and for the full annual depreciation reserve on all equipment.

TABLE V

SASKATCHEWAN POOL ELEVATOR SYSTEM

	Operating Earnings	*Net Operating Earnings*
1931-2	$1,803,874.98	$375,916.44
1932-3	2,797,387.09	814,030.19
1933-4	2,339,082.31	348,153.21
1934-5	2,117,153.59	171,090.20
1935-6	2,103,555.83	152,176.27[25]

Here too, from the first figure, provision was made for payment of the annual obligations to the Saskatchewan government, for depreciation, for loss on realization of assets, etc. In 1933 the pool was finally able to complete its purchase of the old Saskatchewan Co-operative Elevator Company first acquired in 1926. The payments, spread over the seven years, amounted to a total of $13,211,599.94.

Some Recent Developments

Even at the very peak of their power in 1928-29 the three pools had continued their agitation for their ultimate objective—a national wheat board on the 1919 model. The very establishment of the pools in 1924 had been the result of the failure of Western farmers to have a wheat board set up. With the coming of the wheat crisis and the subsequent pool "deflation," it was inevitable that the agitation would be renewed with increased vigour. One of the results of this was the 100% pool movement, centering in Saskatchewan. Legislation was carried through the Saskatchewan legislature providing for a referendum on the matter and for the establishment of an agency if a sufficient number of votes were obtained.[26] The movement died, however, due to insufficient support. One of the main reasons for the pools supporting the World Wheat Agreement was the hope that it would lead to the establishment of a board. In August 1935 the pools finally realized their objective, al-

[25]This does not present the whole picture, for the earnings of the parent body, Saskatchewan Co-operative Wheat Producers Limited, are not given.

[26]Statutes of Saskatchewan 1931, chaps. 87 and 88.

though in a partial from, when the Canadian Wheat Board was set up.

Since December 1930, as has been seen, the Central Selling Agency had been under the general control of Mr. McFarland who had, under government guarantee, been conducting "stabilization" operations. Still the legal co-ordinating agency of the three pools, the agency was actually divorced from them. With the establishment of the wheat board, the stocks in possession of the agency were transferred to it. This left the agency, now neither the direct selling agency of the pools nor the stabilization medium of the government, as an organization without a purpose. However, it has been retained as a legal entity and as a medium unifying the three pools. Its functions are now largely advisory and supervisory.

Included in the some 225,000,000 bushels transferred to the wheat board was an item of some 76,000,000 bushels of wheat delivered to the pools in the 1930-31 crop year. This amount had been kept off the market by Mr. McFarland and used as a "base" for the stabilization operations. Initial payments on this wheat had, as has been noted, ranged from seventy cents to fifty cents. The pools demanded compensation for this wheat and for an amount sufficient to equalize payments on the basis of sixty cents, No. 1 Northern, Fort William. After protracted negotiations between the pools, the wheat board and the federal government, the latter agreed to recognize the justice of the pool claim, and by the "1930 Wheat Crop Equalization Payments Act" authorized the payment of not over $6,600,000 for this purpose. A claim for compensation for coarse grains was refused, although the profit realized on their sale was returned to the pools.

A recent setback to pool aspirations was the announcement of the federal goverment on 27th August 1936 that, although the minimum price of the wheat board of 87½c would remain in force during the 1936-37 crop year, nevertheless the board would not accept deliveries unless the open market price for No. 1 Northern, Fort William, closed below ninety cents. This is in contrast with the policy pursued in 1935-36, and means that the objective of the pools of a compulsory national wheat board has been further emasculated. It is another triumph for the private trade.

The past five years have been extremely difficult ones for the pools. The deflation which they have undergone has been a severe one. Despite all the many vicissitudes, however, the pools have shown themselves readily adaptable to altered circumstances, and to date they have made a remarkable financial recovery. The co-operative movement in Western Canada has, it is true, suffered a sharp setback, but to infer that it is doomed to disappear or to sink into oblivion is to misapprehend completely the strength and vitality of the co-operative sentiment on the Prairies. Of one thing at least there is a certainty—grain growers' co-operation, whatever its form, will not be so quickly or readily abandoned.

SOCIAL CREDIT

By James C. Thompson, F.C.A., Montreal

(Continued from February issue)

Major Douglas and Alberta

On 25th January 1934 Major Douglas wrote to C. V. Kerslake, honorary secretary, Douglas Social Credit League for Canada, Toronto, and suggested that he (Douglas) should be appointed by the government of Alberta as consulting economist for a period of two years. In April 1934 while en route home from New Zealand to England, Major Douglas was asked to expound his theories before the Agricultural Committee of the Alberta Legislature. He agreed to do so provided he was paid $1,250. He gave evidence on 6th and 10th April 1934, and as a result of his evidence and that of William Aberhart and others the committee finally reported in part as follows—

> Your Committee is of the opinion that while the evidence given disclosed the weaknesses of the present system and the necessity for controlled social credit, it did not offer any practicable plan for adoption in Alberta under the existing constitutional condition.
>
> Major Douglas recognized this and urged that a thorough study be made, first, to arrive at a definite objective, and second, to get a clear idea of the obstacles to be overcome and the limitations to be removed in order to clear the way, and the best method of procedure to secure results.[12]

[12]Proceedings from Agricultural Committee, Alberta Legislature, Session 1934.

It was apparent from the evidence given before this committee that there were two separate and distinct schools of social credit and that the Aberhart plan did not commend itself to those who supported Douglas' theories. Mr. Aberhart, through his weekly broadcasts from the Alberta Prophetic Bible Institute in Calgary and through the formation of study groups throughout Alberta, rapidly became the leading exponent of social credit as interpreted by him.

In March 1935, with possibly the desire to play Aberhart against Douglas, the United Farmers of Alberta who were then in power engaged Major Douglas as principal reconstruction adviser. The contract, which was drawn up by Douglas himself, was executed on the 29th March for a term of two years and provided for not more than four but not less than two visits to Alberta. The fee was $5,000 in Canadian currency free from income tax, payable $2,500 on the signing of the contract and the balance on the first anniversary thereof. In addition he was to be granted $2,000 for travelling expenses per trip, plus salary and expenses of a secretary while in Canada and the cost of reasonable press and radio facilities.

Interim Report

On 23rd May Douglas made an interim report and recommended that (1) provision be made for a news circulation system under the unchallangeable control of the Province, particularly in regard to radio facilities; (2) that some credit institution be organized either under the Dominion Bank Act, or otherwise, which would give access to the creation of effective demand (money) through the Credit System, on principles already well recognized and established; (3) that there be a systematic organization directed to the accumulation of what, for the purpose of this report, may be termed "foreign exchange," i.e., effective demand not subject to attack as being recognizable as having been created within the province.

While Douglas was in Alberta he was asked by the then Attorney-General, Hon. J. F. Lymburn, whether he agreed with certain of the policies expounded by Mr. Aberhart. He hedged the question but did state that possibly in the exuberance of an election campaign certain of Aberhart's statements did not correctly interpret social credit principles. This statement of Douglas did not have any ma-

terial bearing on the result of the election as on 22nd August 1935, Aberhart's supporters captured 56 of the 63 seats in the Legislature.

Aberhart and Douglas

William Aberhart was sworn into office as Prime Minister of the province on 2nd September 1935. Two days later he sent a cable to Douglas asking for preliminary instructions. Douglas replied with the suggestion that Aberhart should request banking institutions to credit Alberta with five million dollars. On 24th September, following his return from a trip to Ottawa, Aberhart wrote to Douglas and referred to the five million dollar credit as a matter of detail, and on 15th October Douglas replied that so far from this being the case, although the figure had no special significance, the nature of the transaction which was involved was quite fundamental and vital, and was in line with the second recommendation on the last page of his first interim report. He further advised obtaining a credit of five million dollars from existing banks as a creation on behalf of the government and subject only to the disposition of the government, without interest, the banks being merely paid a sum for the bookkeeping transaction and actual services performed. He also advised the organization of a bank under the Bank Act, or the formation of an institution outside the Bank Act, not issuing notes but creating or granting credits to the government.

On 29th October Douglas wrote again and referred to a conversation which he had had with the Dean of Canterbury. He said that he had gathered from Aberhart's letter of September 24th that he (Aberhart) preferred to work in co-operation with the banks. He did not think that the plan of working with the banks would be successful. He objected to the appointment of R. J. Magor as adviser, as he had been informed that Magor was the nominee of a group of Montreal banks, and suggested that his own contract of 29th March 1935 be terminated.

On 14th November Aberhart cabled to Douglas, "You have been misinformed Magor here our own request to effect reorganization and economies letter following keep steady."

On 27th November Aberhart wrote a long letter to Douglas, which included the statement that "there was absolutely no use bringing you here in September and October

without having even money or financial credit to pay your expenses." It may be observed that Douglas' fee and expenses would have entailed an expenditure of probably $6,000 as compared with the cash revenues of the Province of approximately $50,000 per day. Among other quotations from this letter are: "Nothing can be gained by your assuming the position of dictation rather than that of advice ..... You have already told us that the survey of production, resources and so forth and the registration of our citizens are quite secondary in importance. You have asked us to approach the banks for a credit of five to ten million dollars, with no promise to pay same or pay interest on it. Our Executive Council feels that it cannot approach any bank with such a suggestion at the present time ..... So we therefore ask you ..... your detailed advice regarding our steps of procedure. Be most specific."

Following the receipt of Aberhart's letter it would appear that Douglas began to hedge as he apparently did not wish to give a specific plan of social credit for Alberta. On 11th December he wrote to Aberhart to the effect that the contract was specifically drawn with the thought in mind that it would be necessary to secure control of social credit before any policy could be devised for the disposition of social credit, and pointed out that his contract did not mention social credit but simply appointed him as principal reconstruction adviser. He added that he considered the appointment of a technical adviser (Magor) as a breach of his contract which he suggested should be dissolved. In a later letter he asked for full information regarding the steps taken by the government since it assumed office. Aberhart replied on 24th January and gave details of efforts made by the Province to reduce interest rates and to balance the budget.

During February and March 1936 Douglas from London objected to the procedure being followed by the Alberta government and received by way of answer repeated urgings to come to Edmonton. He did not leave, however, and offered to send a colleague. Finally on 21st March he sent an ultimatum giving the government three days to accept his colleague without contract on the basis of $2,000 for expenses, or "otherwise do best locally." This cablegram was never answered and automatically Douglas' connection with the government was severed.

Failure of Aberhart and Douglas to reach a common understanding is all the more surprising when one remembers (1) that Aberhart prior to his election repeatedly stated that the first thing he would do, if elected, would be to send for Douglas, and (2) that Douglas in his evidence before the Agricultural Committee of the Alberta Legislature said, "Given the power either I or dozens of other people could provide you in three months with a scheme which would work perfectly and put Alberta or Canada, depending on the extent to which it is applied, forever outside the range of poverty; but you cannot do it because you won't be allowed and it is your problem to find out how to get the power to put into operation a technically sound scheme."

Alberta Under a Social Credit Government

With the election of the Social Credit government in August 1935, Alberta entered into what may be termed a period of default. With the exception of advances by the Dominion of Canada, all sources from which funds could be obtained were closed and the government found itself unable to meet its obligations.

Prior to the election, investors in provincial savings certificates became uneasy as to the safety of their deposits. At 31st March 1935 savings certificates outstanding amounted to $10,874,000. During the next four months depositors withdrew $600,000 and in the month of August a further sum of $860,000. The run on the provincial treasury immediately before and after the election of 22nd August became so serious that it was necessary for the retiring government to suspend payment. At the end of August 1935 certificates outstanding amounted to $9,414,000 and at the end of June 1936 to $9,008,000. The new government between August 1935 and June 1936 provided from ordinary funds $406,000 to meet the demands of necessitous cases. It has been unable, however, to arrange any method whereby the remaining $9,008,000 will be repaid. On 15th January 1936 a bond maturity of $2,000,000 was met by the Dominion advancing $1,577,000, the balance being supplied from the provincial sinking fund. On 1st April 1936, due to the government's refusal to accept the proposed loan council, Alberta defaulted on a maturity of $3,200,000.

On 31st May 1936 the government by order-in-council cut the interest rate of all bonds and savings certificates

by 50%, with the provision that a minimum of 2% would be paid. On 1st November 1936 the province again defaulted by failing to meet a maturity of $1,250,000.

Shortly after his election to office, Mr. Aberhart proceeded to Ottawa and arranged for a loan of $2,250,000 from the Dominion government, which relieved immediate cash requirements but did not provide for the payment of saving certificate deposits. When in the East, he retained the services of a well-known Montreal industrialist, Mr. R. J. Magor, as financial adviser. This appointment, as previously stated, was largely accountable for the split between Mr. Aberhart and Major Douglas. In the appointment of Mr. Magor, an orthodox financier, and in his desire to balance the Alberta budget, Mr. Aberhart proceeded along purely orthodox lines—in sharp contrast to his later policies and his social credit views. The 1936-37 budget provided for additional taxation chiefly through the medium of a retail sales tax, increased income taxes and an increase in land taxes. Steps were also taken to prevent evasion of the tax on gasoline. Controllable expenditures were not reduced but showed an increase over the level of the preceding year.

Three Important Acts Passed

At the 1936 (first Session) of the legislature the government passed three important acts, namely, the Social Credit Measures Act, the Provincial Loans Refunding Act, and the Licensing of Trades and Businesses Act.

The Social Credit Measures Act authorized the government to investigate and formulate proposals leading to the introduction of social credit. The Act did not authorize the introduction of social credit but simply measures leading up to it. The Provincial Loans Refunding Act provided for a compulsory refunding of the public debt of the province but was only to come into effect upon proclamation. This Act has not yet been proclaimed. The Licensing of Trades and Businesses Act gave fairly wide powers to the Lieutenant-Governor-in-Council to regulate trade within the province, largely by the introduction of codes.

Towards the close of the session it became apparent that considerable pressure was being exercised on the government by the back-benchers who had as their chief spokesman Mr. Lucien Maynard. Shortly after the session closed

Mr. Maynard was taken into the cabinet as minister without portfolio and was specifically charged with the duty of bringing in a working plan for social credit.

On 31st May the government by order-in-council reduced interest rates on the provincial debt by 50%, a reduction for the fiscal year of 2.3 million dollars and in future years of 3.6 million dollars.

Issue of "Scrip"

It will be remembered in his interim report Douglas recommended the creation of effective demand and the accumulation of foreign exchange. These recommendations should be borne in mind in tracing subsequent events.

By order-in-council on 11th June 1936, the provincial treasurer was authorized to issue Alberta prosperity certificates, commonly designated as "scrip," in denominations of $1 and $5 up to a maximum of $2,000,000. These certificates were to be issued to any persons willing to accept them in respect of claims against the government. The order-in-council provided that certificates would be redeemed after the expiration of two years from the date of issue provided that at the time of presentation there were attached to each certificate 104 certificate stamps of 1c denomination for $1 certificates and 5c for $5 certificates, which stamps represented 1% of the denomination of the certificate. The treasurer was authorized to sell stamps to the public and to place the proceeds in a special trust fund which was to be used for the purpose of redeeming the certificates and the expenses incidental to the issue.

In July 1936 the government announced that $5,000 would be paid in each provincial constituency in prosperity certificates as wages for road work to be conducted under the supervision of the local member. Under this plan some $236,000 was paid out in August. At the same time the government announced that certificates would be cashed at their face value on each Thursday and Friday following the second Wednesday in each month provided stamps covering the period between the date of issue and the date of redemption were duly fixed thereto. In addition, the government announced that certificates would be accepted monthly by the provincial treasurer in payment of sales tax. According to press reports certificates to the extent of $141,000 were presented for redemption in September and

$25,000 reissued. In October it is stated that $69,000 were redeemed, leaving the sum of $51,000 still in circulation, of which probably $10,000 represent souvenirs in the hands of the public.

In order to provide some avenue through which scrip could be regularly issued in future, members of the civil service were requested to co-operate by accepting a percentage of their salaries in certificates each month or by purchasing a number of certificates from the proceeds of their salaries. The government announced that no penalty would be inflicted on those who did not co-operate. In passing, it is of interest to know that scrip was tried in one of the counties of the State of Oregon in 1933 and failed, the certificates being finally liquidated at ten cents on the dollar.

Looking at the Alberta scrip experiment at this date, it would appear that an attempt was made to follow recommendation No. 3 of the Douglas interim report in an effort to accustom the Alberta public to the use of money other than notes of chartered banks or Dominion currency. The government was forced to depart from its original plan of keeping certificates in circulation for two years by providing for redemption within six weeks of the first certificates being issued. To the extent new work was provided, payment was finally made from ordinary provincial revenues, thus decreasing the cash resources of the government. The experiment generally was a failure as it simply introduced one more step into the ordinary machinery of payment. In the final analysis it is safe to state that the administrative costs will equal any profit made by the government through the sale of stamps.

Registration

In July and August 1936 an intensive campaign was conducted to have every citizen register for social credit purposes. Forms were provided for the registration of individuals, farmers, retailers and manufacturers. The forms asked for information about the individual's assets and liabilities and his revenues and expenditures, and in each case it was necessary for the applicant to sign a covenant, the chief provisions of which were: (1) to co-operate with the government; (2) to accept whenever possible a portion of his remuneration in Alberta credit instead of Canadian

currency; (3) to make no claim nor demand for payment in Canadian currency of Alberta credit held by him; and (4) to tender no Alberta credit in payment of sums due the government and in the case of farmers to accept up to 50% Alberta credit in payment of his products.

It was provided that registrations would be accepted in August and September of the year 1936 and in the month of June each year thereafter. Under the plan there is gross discrimination against those who do not register, as the alleged benefits are confined to those who sign the covenants. Some 376,000 citizens registered, a larger number than the total votes cast in favour of social credit at the general election in August 1935. While the registration was under way the government called a special session of the legislature and passed three important Acts—The Alberta Credit House Act; The Department of Trade and Industry Amendment Act; and The Reduction and Settlement of Debts Act.

State Credit House

Under the Alberta Credit House Act provision is made for the establishment of a large co-operative institution. As previously stated, only those persons registered under the Act will be entitled to receive the benefits of Alberta credit, and wide powers are given to the superintendent of the credit house. The principal functions of the credit house are: (a) To provide every person entitled to Alberta credit with the amount of any Alberta credit to which he may become entitled in such manner as may be prescribed by the Lieutenant-Governor-in-Council; (b) To receive deposits of Alberta credit vouchers and all transfers of Alberta credit made in conformity with the Act from any depositor thereof and to keep an account of all such Alberta credit so received and transferred; (c) To receive currency of all kinds and negotiable instruments from any person and to convert the same into Alberta credit for an amount expressed in terms of currency equal to the currency and negotiable instruments so received and to make available to such person Alberta credit for the amount thereof; (d) To take any or all of the assets of the credit house for the payment of debts of the province.

To summarize, the Alberta credit house is empowered to conduct a banking business within the province, using

Alberta credit as the chief medium of exchange. Power is given to the executive council to vary or supplement with new provisions any of the provisions of the Act for the purpose of providing for matters arising out of the operation of the Act for which no express provision is made. In other words, government by order-in-council.

Let us assume that all citizens are prepared to co-operate in the establishment of the state credit house and that there are no legal or technical difficulties. Presumably, the first step will be for the superintendent to call for each registered farmer to accept Alberta credit for 50% of his crop, and for citizens and others to accept Alberta credit in payment for goods and services. We shall assume also that cash and securities are willingly turned in to the credit house by all those who signed the covenants.

The state credit house will have cash or securities as assets and will owe depositors a similar sum. Depositors will no doubt desire to use their accounts in the state credit house and will issue cheques or tickets in payment of goods or services. Assuming that these tickets are cleared through ordinary trade channels, they will then be presented for payment to the state credit house and the cash resources of the credit house will be reduced accordingly. Provided the functions of the state credit house are confined purely to a banking business and expenses are met by the government, the loss to the province will be the cost of operation. The Act, however, provides that the assets of the state credit house may be used to discharge debts of the province. In other words, the state credit house will lend to the government the funds it has on deposit. If too large a percentage of state credit house funds are transferred to the government then the credit house will not be able to meet the demands of depositors.

Once dividends are credited to all citizens, such dividends become a liability of the state credit house, with no corresponding asset, unless the government supplies the necessary funds by taxation or borrowing. If scrip or tickets are issued, inflation automatically results, with the effect already stated.

Amendments to the Department of Trade and Industry Act provide for the creation of a price spreads board to fix and prescribe maximum or minimum prices at which

goods, wares or merchandise shall be sold whether by wholesale or retail.

The Reduction and Settlement of Debts Act provides for the application against principal of all interest paid on debts owing by individuals as at 1st July 1932, and for the spreading of the balance remaining over a further period of ten years without interest. For debts incurred after 1st July 1932 the Act provides for maximum interest charges of 5%.

Douglas Theories in 1936 Legislation

There is obviously a direct relationship between Major Douglas' recommendations and the above legislation. Provision has been made for the use of scrip instead of Dominion currency and Alberta credit instead of ordinary banking facilities. By exchanging securities or paying Alberta farmers in Alberta credit for 50% of their products a foreign exchange fund will be established, and by the debt reduction legislation interest and principal payable on extra-provincial debts will remain in the province, thus helping to create a favourable balance of trade. Price control is authorized by legislation. In Alberta today there are some 400,000 citizens twenty-one years of age or over of whom 376,000 have actually registered under the social credit plan. Monthly dividends of $25 per month for 400,000 citizens will require the sum of $10,000,000 monthly to be recovered, according to the plan, by levying on the spread between the cost and the selling price of goods. Alberta's retail sales in 1934 amounted to some 120 million dollars, and it would appear that prices of commodities would need to be doubled in order that the state may issue monthly basic dividends to its citizens. Certain weaknesses are immediately apparent—(1) Alberta has no control over inter-provincial trade; (2) Alberta has no power to force the acceptance of Alberta credit instead of legal tender; (3) Alberta credit will automatically replace Dominion currency and unless redeemed almost as quickly as issued will fall to a substantial discount; (4) Prices of goods in terms of Alberta credit will rise, and if one is able to judge from experience elsewhere, any attempt at price control will be abortive; and (5) The experiment will be expensive.

While 376,000 citizens have under a covenant promised to co-operate, will they do so to the extent of paying enhanced prices for goods purchased in Alberta as compared

with the saving by purchasing the same goods elsewhere? Unless forced to do so, will they accept Alberta credit instead of legal tender? Will the recipients of dividends be satisfied when they find that the real value of their total income is less than before the introduction of the scheme?

Alberta is not a self-contained state. It must exchange its products for the products of other communities. The Alberta merchant will find that manufacturers elsewhere will demand Dominion currency for commodities and unless he is able to obtain Dominion currency he will not be able to replenish the goods on his shelves. This will rapidly lead the local merchant either to bankruptcy or to the point where he will refuse to accept Alberta credit as payment for commodities.

The experiment is bound to be expensive; an army of officials will be required in the various branches of the State credit house and for the purpose of controlling prices. Confidence in Alberta has been destroyed by the actions of the present government, capital is being withdrawn, and very little new capital will enter the province until such time as the present experiment has been tried by practical application. Unemployment has increased and in all probability will continue to increase until confidence is restored.

As the present government was elected with a clear mandate to introduce social credit, no interference should come from the outside. The experiment, in my opinion, will fail and fail miserably. When failure does come Alberta will need help and it is to be hoped that such help will be generously extended by all those who believe as I do that Alberta has a glorious future, provided the resources and wealth of the province are developed along sane and sound lines.

GENERAL NOTES

Meeting of Executive Committee

The mid-year meeting of the Executive Committee of The Dominion Association of Chartered Accountants was in progress when our March issue went to press. A report of the meeting will be published in the April issue.

Our Contributors This Month

ARTHUR I. BLOOMFIELD, who is a native of Montreal, was a member of the class of 1935 in economics and political science of McGill University and was awarded the Allen Oliver gold medal and a graduate fellowship on graduation. He spent a further year at McGill in graduate studies and received the degree of Master of Arts in 1936. He is attending the University of Chicago for the next two years in studies leading to the degree of Doctor of Philosophy. In his graduate year at McGill he made a special study of the Western wheat pools, on which subject he writes in our issue this month.

ARTHUR EDWIN CUTFORTH, of London, England, needs no introduction to members of the profession in Canada. He is the immediate Past President of the Institute of Chartered Accountants in England and Wales and is a member of the Institute of Chartered Accountants of Ontario. While he is author of several standard textbooks, including "Audits," "Public Companies and the Investor," "Methods of Amalgamation," and "Foreign Exchange," he has the happy faculty of being able to turn aside from the serious things of professional life, and has written a few small works of fiction. Among the public appointments which he has filled are: accountant-assessor to the Royal Commission on the Coal Industry in 1925, a member of the Panel of Arbitrators under the Central Coal Mines Scheme, 1930, a member of the Consultative Committee under the Milk Marketing Scheme and of the Consumers' Committee for Great Britain under the Agricultural Marketing Act. He is a member of the firm of Deloitte, Plender, Griffiths & Co., chartered accountants, London, and was made a C.B.E. in 1926. We are privileged to bring to our readers this month Mr. Cutforth's fine address on balance sheets, their use, abuse and limitations.

We welcome again this month PHILIP HOWARD HENSEL who wrote on the advantages and uses of budgets in our January issue. Mr. Hensel is Head of the Department of Business Administration of the University of Western Ontario and discusses this month the "Retail Method of Inventory Control."

WILLIAM MACINTOSH, whose essay "Fund Consciousness—A Forgotten Aspect of Commercial Accountancy," won second prize in The 1936 Essay Competition and is published this month, was born in Edinburgh, Scotland. He was educated at George Watson's College, Edinburgh, and at the Saskatoon Collegiate Institute. He also took some studies at the University of Saskatchewan and McGill University, but owing to ill-health was forced to discontinue his course before graduation. He passed the final examinations of the Institute of Chartered Accountants of British Columbia in 1932, and is engaged in accounting practice with the firm of Helliwell, Maclachlan & Co., chartered accountants, Vancouver, B.C.

We publish this month the latter half of the address on "Social Credit," given by JAMES COTTEW THOMPSON, concerning whom we made reference among our contributors in the February issue.

Comments and Descriptions in Annual Reports of Corporations

At page 156 of the February issue were published some comments and descriptions which appeared in recent published financial statements of companies incorporated under Dominion statute. Comments and descriptions appearing in other financial statements are given below.

The publication of such comments here from time to time is not necessarily to be regarded as approval of the form thereof by the Editorial Committee or by the Dominion Association of Chartered Accountants but rather as information for readers.

1. The Auditors' Report dated 5th January 1937 to the shareholders of *Gypsum, Lime and Alabastine, Canada, Limited* (Dominion charter) is as follows:

> We have made an examination of the accounts of Gypsum, Lime and Alabastine, Canada, Limited and its wholly owned Sub-

sidiary, Crystalite Products Limited as at 30th November, 1936. In connection therewith we examined or tested the accounting records and obtained all the information and explanations we required from the officers and employees; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions. We have received a balance sheet of Standard Lime Company Limited as at 30th November 1936, audited by Messrs. Riddell, Stead, Graham & Hutchinson, Chartered Accountants, and the assets and liabilities of that company as shown by such balance sheet have been included in the above consolidated balance sheet.

Subject to the foregoing and to the sufficiency of the provision for depreciation, we report that in our opinion the above consolidated balance sheet has been drawn up in accordance with accepted principles of accounting and on a basis consistent with the preceding year, so as to exhibit a true and correct view of the state of the Companies affairs as at 30th November, 1936, according to the best of our information and the explanations given to us and as shown by the books.

As required by The Dominion Companies Act, Section 114, we report that provision has been made in the accompanying statements for all losses incurred by subsidiary companies making losses during the year and not consolidated therein.

2. In the balance sheet of *Dominion Stores Limited* (Dominion charter) the following appears:

Merchandise Inventories, determined by physical stocktaking for warehouse and meat stocks and book inventories (verified monthly) for store grocery stocks, and valued at cost or estimated cost, which basis is not higher than market value, as certified by the management ....$

Auditors' Report to the Shareholders:

We have made an examination of the balance sheet of Dominion Stores, Limited, as at December 26th, 1936, and of the profit and loss and earned surplus accounts for the year ending on said date. In connection therewith we examined or tested the accounting records and other supporting evidence and made a general review of the accounting methods and of the operating and income accounts for the year but did not make a detailed audit of the transactions.

We have obtained all the information and explanations we have required, and, based upon such examination, report that, in our opinion, the above balance sheet as at December 26th, 1936, is properly drawn up so as to exhibit, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, a true and correct view of the state of the affairs of Dominion Stores, Limited, according to the best of our information and the explanations given us, and as shown by the books, and that the related profit and loss and earned surplus accounts fairly present the operating results for the year.

3. The Auditors' Report to the Shareholders of *The Toronto General Trusts Corporation* (Dominion charter) is as follows:

We have verified the Investment Securities and Cash and Bank Balances held at Toronto for the Corporation's Capital Account, as well as those held for Guaranteed and Savings Funds, for the Supreme Court of Ontario and for the Trust Estates and Agencies administered by the Corporation, as at 31st of December, 1936. The securities and funds held for Trust and Guaranteed Accounts and for the Supreme Court of Ontario are kept separate from the Corporation's own securities and funds, and are so ear-marked on the books of the Corporation as to show the accounts to which they belong.

Government, Municipal and other Bonds and Stocks, held for Capital and Guaranteed Accounts are shown at market values.

The Assets and Liabilities at your Branches have been certified to by your Branch Auditors and have been incorporated with the Head Office Accounts in the attached Balance Sheet as of 31st December, 1936.

Owing to the unfavourable conditions which have prevailed in Western Canada for some years past, and owing to moratorium legislation, payment of interest and taxes has not been made in whole or in part by a substantial number of Western debtors. Under these conditions and because of debt legislation passed by the Province of Alberta, which Counsel have advised is invalid, and is now before the Courts, we have been unable to form an opinion at the present time as to the position of mortgages, agreements for sale and real estate held by the Corporation in Western Canada.

After due consideration we have formed an independent opinion of the position of the Corporation on 31st of December, 1936 and we report that in our opinion so formed and according to the best of our information and explanations given us, the accompanying balance sheet, subject to the foregoing, sets forth fairly and truly the position of the Corporation on that date and is in agreement with the books of the Corporation.

All transactions of the Corporation that have come within our notice have, in our opinion, been within the powers of the Corporation.

We have received all the information and explanations we have required.

Company Legislation in Canada

In response to an inquiry in the House of Commons on 2nd February last as to the progress being made by the Dominion and Provincial governments in bringing about a greater degree of uniformity in company legislation in Canada, the Honourable Fernand Rinfret stated that at a meeting of the committee of Dominion and Provincial officials held in Ottawa 3rd to 7th November last excellent progress had been made. Sub-committees were set up to deal with particular branches of the subject and these will report at another meeting of these officials to be held during next summer or early autumn.

"The committee reviewed very carefully the prospectus

sections of the present Dominion Companies Act," Mr. Rinfret stated, "and decided to recommend the adoption of prospectus sections which are based very largely on those in the present Dominion act. Since the amendments suggested by the committee in regard to the prospectus sections dealt largely with form and not with the substance of these sections, I have not considered it necessary to recommend amending legislation at this session of Parliament. It appears possible that the committee, at its next general meeting, may make such further progress as to enable it to submit to the government a draft bill which would deal with other important provisions of the present Act, and which might involve a general revision of the Act.

"In addition to dealing with the question of proposed legislation, the committee has been able to make substantial progress in arranging for a better exchange of information on questions of administration not only of the Companies Acts but also of the Securities Acts of the Provinces."

Safeguarding Trust Funds

In our Editorial Comments last month it was stated that so far as we were aware only in Alberta and Ontario had the Law Society adopted definite rules respecting accounts. Since then we have been informed that two years ago the Benchers of the Law Society of Manitoba passed rules in this regard.

LEGAL DECISIONS

[Editor's Note: The following are brief summaries of recent decisions of the Canadian Courts as taken, by the kind permission of the Canada Law Book Company, from the *Dominion Law Reports.* In each case reference is made to the volume of the *Reports* where the full judgment may be found. It should be kept in mind that the decisions given may not always be final.]

Executors—Accounting—Negligent handling of funds—Liability on bond

(Benjamin et al. v. *Haskell et al.)*

Ontario Supreme Court

An administrator acting for infant beneficiaries, who without retaining control has turned over funds to his solicitor to be paid to the official guardian of the infants pursuant to an accounting in the Surrogate Court, which funds were never received by the guardian, is guilty of gross negligence and breach of trust in the administration of the estate, and together with his sureties is liable on his bond; in such case he cannot successfuly invoke on his behalf the provisions of ss. 20, 30 and 34 of the Trustee Act, R.S.O. 1927, c. 150.—[1936] 4 D.L.R. 465.

Companies—Directors' liability—Loans to shareholders—Unpaid sales tax

(The King v. *Kussner)*

Exchequer Court of Canada

Section 112 of the Companies Act, R.S.C. 1927, c. 27, renders directors of a company liable to its creditors not only for debts of the company existing at the time a loan to any shareholder is made but also for debts contracted between the time of the making of such loan and its repayment; hence the Crown may recover from directors an amount due for sales tax during the years loans to them remained outstanding and the fact that a proposal under the Companies' Creditors Arrangement Act has been made and sanctioned by the Court does not affect the rights of the Crown.—[1936] 4 D.L.R. 752.

(Note: A brief review of this case appeared on pp. 56-59 of the January 1937 issue of The Canadian Chartered Accountant).

Income tax—Annuity chargeable upon corpus of estate—Whether taxable as income

(Toronto General Trusts Corp. v. *Minister of National Revenue)*

Exchequer Court of Canada

An annuity chargeable upon the corpus of an estate rather than being payable out of a settled fund and not dependent upon the production or use of any real or personal property in particular is a gift and not taxable as "income."—[1936] 4 D.L.R. 533.

(Note: A brief review of this case - - known as the *Whitney* case - - appeared on pp. 232-235 of the September 1936 issue of THE CANADIAN CHARTERED ACCOUNTANT).

Income tax (Manitoba)—Undistributed profits of one company received as dividends by another

(Jackson & Sons v. *Municipal Commissioner)*

Supreme Court of Canada

The undistributed profits of a joint stock company, not a personal corporation received as dividends by another such company in 1934 although accumulated prior to 1929 are taxable as income under s. 8(4) of the Income Tax Act. The exempting section, 4(p.), applies only to profits in the hands of the accumulating company and would not relieve the beneficiaries on distribution. It is the amount of the income not the specie in which it is received that is the basis for taxation.

Waterous v. *Minister of National Revenue,* [1933] 3 D.L.R. 502, applied.—[1936] 4 D.L.R. 529.

PROVINCIAL NEWS

ONTARIO

Following are the results of the examinations of the Institute of Chartered Accountants of Ontario written in December 1936. The candidates who wrote were from various points in the province, and in particular from Toronto, Ottawa, Windsor, Hamilton, London, Kitchener, Sudbury and Timmins. One hundred and thirty-one candidates were successful, of which forty-four wrote the Primary, forty-five the Intermediate, and forty-two the Final examination.

The prize winners were as follows: *Primary*—first prize, J. R. Morrissey, Brantford; second prize, Irving Beckerman, Toronto. *Intermediate*—first prize, F. K. Orme, Ottawa; second prize, George Wishart, Toronto. *Final*—Institute gold medal, J. A. Rogers, Kirkland Lake; George Edwards prize, Holland Pettit, Jr., Toronto; W. T. Kernahan prize, Gerald H. Sprague, Toronto; and E. R. C. Clarkson gold medal, Ben Sobel, Toronto.

The prizes and diplomas were presented at the mid-winter dinner and reception to new members held in the Royal York Hotel on 19th February, at which the guest speaker was Mr. George O. May, F.C.A., of New York. Following is a complete list of the successful candidates:

Primary—A. M. Adamson, H. A. Agar, J. D. Anderson, A. A. Bailie, Irving Beckerman, R. A. Burns, G. K. C. Campbell, S. C. Costigane, J. A. Dickson, Albert Freedman, A. E. Gignac, John W. Glendinning, Harold Gorman, Murray Grossman, G. R. Herington, Harry Heyes, G. O. Huggan, W. E. Kime, Roger Levesque, F. J. Lovett, B. W. Matthews, Harold A. Morris, John R. Morrissey, R. L. McCarthy, Neil A. McRae, W. T. O'Donnell, J. A. Ovens, Leon Panzer, Meyer Perlmutter, John S. Petrie, Morton W. Rashkis, H. C. Rogers, R. A. Simpson, G. P. Smith, N. H. Solmon, H. A. Starr, B. T. Stephenson, G. F. Stiff, A. B. Stokes, B. W. Varty, A. D. Ward, J. C. Webb, C. R. Welch, Harry Wood.

Intermediate—S. E. S. Bain, M. M. Basen, A. I. Cohen, G. L. Court, R. B. Cranston, F. L. Davies, W. P. Deeth, A. J. Douglas, John Ewart, R. W. Greene, W. M. Griffith, J. K. Hagan, J. D. Hankinson, Keith L. Hamer, J. E. Hicks, R. O. Holditch, A. H. Howson, S. M. Hulbig, G. A. Kilner,

J. M. Lavery, R. T. M. LeMay, William Levine, A. J. Little, A. R. MacCallum, A. F. MacLaren, R. J. Middleton, R. B. Moran, R. D. Munnoch, F. K. Orme, A. C. Papoff, D. S. Perigoe, J. C. Robertson, W. E. Robinson, E. H. Savlov, E. B. Smith, G. H. Spence, J. J. Stephenson, D. R. Strong, M. B. Tennant, J. H. Turner, J. C. Vanstone, R. W. Williamson, K. A. Wilson, George Wishart, G. T. N. Woodrooffe.

Final—J. N. E. Amsbury, L. E. Barker, R. G. Britnell, A. L. Brown, P. G. Bruce, Frank K. Carlisle, W. P. Carr, S. F. Chapman, G. W. Christie, J. M. Clark, G. P. Clarkson, W. C. Crofton, S. G. Cruttenden, G. E. Footit, Hugh L. Gordon, W. L. Hogg, T. C. Kinnear, T. W. Langstone, N. A. B. MacEachern, W. H. MacKay, J. G. B. Mathewson, J. A. Medland, H. F. Mellor, H. G. Nunn, Leon Papernick, Holland Pettit, Jr., B. B. Puddy, W. A. Ralph, K. L. Reid, G. P. Rice, W. W. Richardson, J. A. Rogers, S. B. Rose, John C. Ross, W. Grant Ross, Theodore Simpson, Ben Sobel, R. S. Sommerville, G. H. Sprague, M. S. Sutherland, L. W. Trumble, James C. Wilson.

Supplementary Examinations—The following passed in all but one subject in the Final examination and have been granted a supplementary examination: *Accounting*—M. A. Honeywell, W. R. Lugsdin, Frank C. Putt; *Business Investigations*—B. M. Clancy, E. M. Curran, J. D. Green, N. E. Hamilton, C. G. Rounding; *Economics and Business Finance*—Gordon W. Benson, Paul W. Boultbee, D. B. Crawley, C. F. Glennie, L. E. Lugsdin, D. J. McClellan, and E. Sprachman.

PERSONAL

Mr. I. C. Schacter, chartered accountant, formerly with Messrs. Gladwell, Wilson & Co. of Regina, has become also a member of the Manitoba Institute and is carrying on his professional practice under the firm name of George Loos & Company, 202 Paris Building, Winnipeg.

OBITUARY

The Late Angus McColl Parker

The Institute of Chartered Accountants of Ontario regrets to announce the sudden passing at Toronto on February 14th of Angus McColl Parker.

The late Mr. Parker had been a member of the Ontario Institute since 1920 and was also a member of the Institute of Accountants and Actuaries in Glasgow. For the last eight years he had been on the staff of the Audit Department at the City Hall prior to which he had held the position of Chief Accountant at The Toronto General Hospital.

Surviving are one sister and one brother to whom the Institute extends sincere sympathy.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

Industries operating under conditions of joint supply present the accountant with the problem of by-product and joint product "costing." The conventional procedure with regard to by-products is to credit the proceeds of sale of these (less the expenses of selling) in reduction of the cost of the main product. The result is not in reality the cost of the main product but yet it is a significant figure because it is the amount which the manufacturer must realize from sale of the main product if he is to break even on his operations.

Cost accounting texts offer a variety of methods for determination of the separate cost of each of a number of joint products. It is sometimes said that the only rational method is to cost joint products in proportion to their selling prices. In this way the cost will move with the selling prices and each product will so to speak be loaded with what it will bear. It is, however, difficult to believe that there is anything rational or logical in this procedure. It involves a good deal of arithmetical calculation but that is not in itself a virtue. The resultant figures of so-called "costs" are of no use in determining selling prices for they are themselves derived from selling prices; they are of no use in determining the efficiency of productive operations for they are based on an assumption of equal efficiency in all products.

* * *

It is submitted that in all situations of joint cost the manufacturer should confine himself (a) to computing the conversion cost (labor plus factory service) of each operation (such as splitting the joint product, further processing of each joint product), so as to maintain efficiency in each operation. (b) to matching continually the total cost of a lot of joint products against the total sales value of these products so as to determine the price that can be paid for the raw material.

This is in effect what is done in the hog packing industry which has probably devoted more thought to the problem of joint product accounting than any other industry. It is a procedure particularly appropriate where the raw material can be developed into alternative products, or where there is a choice between selling a joint product in the condition in which it exists at the point of split off or of further processing it.

All of this amounts to saying that under conditions of joint supply the market price of the joint products determines the quantity in which the manufacturer will purchase raw materials from day to day and the prices which he can afford to pay for those raw materials.

* * *

One of the commonest arguments advanced in support of the practice of "costing" joint products by apportioning total cost on the basis of selling prices of the several products is that cost *must* be ascertained for inventory purposes. Since, as a matter of scientific fact, the relative total cost of each of several joint products cannot be computed* and is certainly not obtained by this apportionment would it not be sensible to recognize these things and in all joint product industries (as in the packing industry) to value inventories at selling prices less estimated selling expense?

* * *

In Memoriam—Frederick John Charlewood

The students of British Columbia were grieved to learn of the death, during the Christmas holidays of Frederick John Charlewood, in his twenty-sixth year.

Mr. Charlewood had attended Brentwood College in Victoria and was well known in both Victoria and Montreal. For eighteen months prior to his death he had been articled to Mr. Richard C. Field, chartered accountant, of Victoria.

*But see e.g. Marshall, *Principles of Economics* (Fourth Edition), p. 438 or Henderson, *Supply and Demand*, pp. 68 and 69 for the method of calculating the *marginal* cost of each of two joint products whose proportions can be varied at will.

PROBLEM AND SOLUTION

Solutions presented in this section are prepared by a practising chartered accountant of the Institute from whose examinations the problem is taken and represent his views and opinions. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ALBERTA.

INTERMEDIATE EXAMINATIONS—APRIL, 1936

Accounting No. 2—Practical. Question 3

A. Short, Red Deer and D. Long, Edmonton, Printers, agree to incorporate their respective businesses under the name of Short and Long Limited, with an authorized capital of $700,000.00 consisting of 3,000 7% Preferred Shares of $100.00 each and 4,000 Common Shares of $100.00 each. The terms of the agreement are as follows:

A. Short receives 1,000 7% Preferred Shares and 2,000 Common Shares for his business.

D. Long receives 750 7% Preferred Shares and 750 Common Shares for his business.

A. Short is also to receive 250 Common Shares in consideration of his services in connection with the incorporation.

From the following Balance Sheets of A. Short and D. Long make the necessary journal entries in the books of the new company to give effect to the incorporation and prepare balance sheet of Short and Long Limited.

A. Short

Balance Sheet at 31st December, 1935

Assets

Cash	$ 3,000.00
Accounts Receivable	5,000.00
Bills Receivable	20,000.00
Stock on hand	80,000.00
Plant and Equipment	60,000.00
Real Estate	104,000.00
	$ 272,000.00

Liabilities and Capital

Accounts Payable	$ 2,000.00
Bills Payable	8,000.00
Mortgage Payable	12,000.00
A. Short, Capital	250,000.00
	$ 272,000.00

D. Long
Balance Sheet at 31st December, 1935

Assets

Cash	$ 2,000.00
Accounts Receivable	5,000.00
Bills Receivable	15,000.00
Plant and Equipment	56,000.00
Stock on hand	30,000.00
	$ 108,000.00

Liabilities and Capital

Bills Payable	$ 8,000.00
D. Long, Capital	100,000.00
	$ 108,000.00

SOLUTION

The consideration to be received by Messrs. Short and Long for their respective businesses is:—

	A. Short	D. Long
7% Preferred Shares	$ 100,000.00	$ 75,000.00
Common Shares	200,000.00	75,000.00
	300,000.00	150,000.00
Their capital accounts at 31st December 1935 are	250,000.00	100,000.00
Amount by which consideration exceeds capital	$ 50,000.00	$ 50,000.00

The excess represents the amount to be paid for the goodwill of the respective businesses. The following are the amended Balance Sheets of A. Short and D. Long at 31st December 1935 after providing for the goodwill shown above.

A. Short
Amended Balance Sheet at 31st December 1935

Assets

Cash	$ 3,000.00
Accounts Receivable	5,000.00
Bills Receivable	20,000.00
Stock on hand	80,000.00
Plant and Equipment	60,000.00
Real Estate	104,000.00
Goodwill	50,000.00
	$ 322,000.00

Liabilities and Capital

Accounts Payable	$ 2,000.00
Bills Payable	8,000.00
Mortgage Payable	12,000.00
A. Short, Capital	300,000.00
	$ 322,000.00

D. Long

Amended Balance Sheet at 31st December 1935

Assets

Cash	$ 2,000.00
Accounts Receivable	5,000.00
Bills Receivable	15,000.00
Plant and Equipment	56,000.00
Stock on hand	30,000.00
Goodwill	50,000.00
	$ 158,000.00

Liabilities and Capital

Bills Payable	8,000.00
D. Long, Capital	150,000.00
	$ 158,000.00

The opening entries in the books of Short and Long Limited are as follows:—

Cash ....Dr.	$ 3,000.00	
Accounts Receivable	5,000.00	
Bills Receivable	20,000.00	
Stock on hand	80,000.00	
Plant and Equipment	60,000.00	
Real Estate	104,000.00	
Goodwill	50,000.00	
To Bills Payable		$ 8,000.00
Mortgage Payable		12,000.00
Accounts Payable		2,000.00
A. Short		300,000.00
To record assets and liabilities of A. Short taken over as per agreement.		
A. Short ....Dr.	$ 300,000.00	
To 7% Preferred Shares		$ 100,000.00
Common Shares		200,000.00
To record shares allotted to A. Short		
Cash ....Dr.	$ 2,000.00	
Accounts Receivable	5,000.00	
Bills Receivable	15,000.00	
Plant and Equipment	56,000.00	
Stock on hand	30,000.00	
Goodwill	50,000.00	
To Bills Payable		$ 8,000.00
D. Long		150,000
To record assets and liabilities of D. Long taken over as per agreement		
D. Long ....Dr.	$ 150,000.00	
To 7% Preferred Shares		$ 75,000.00
Common Shares		75,000.00
To record shares allotted to D. Long		
Organisation Expense ....Dr.	$ 25,000.00	
To Common Shares		$ 25,000.00
To record shares allotted to A. Short in consideration of his services in organising the company		

Short and Long Limited

Balance Sheet at 31st December 1935

Assets

Current		
Cash	$ 5,000.00	
Accounts Receivable	10,000.00	
Bills Receivable	35,000.00	
Stock on hand	110,000.00	$ 160,000.00
Fixed		
Real Estate	104,000.00	
Plant and Equipment	116,000.00	220,000.00
Goodwill		100,000.00
Organisation Expense		25,000.00
		$ 505,000.00

Liabilities and Capital

Current		
Accounts Payable	$ 2,000.00	
Bills Payable	16,000.00	$ 18,000.00
Mortgage Payable		12,000.00
Capital		
Authorised		
3000 7% Preferred Shares of $100.00 each	300,000.00	
4000 Common Shares of $100.00 each.	400,000.00	
	700,000.00	
Issued		
1750 7% Preferred Shares of $100.00 each	175,000.00	
3000 Common Shares of $100.00 each.	300,000.00	475,000.00
		$ 505,000.00

Problem 2.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ALBERTA

FINAL EXAMINATIONS—APRIL, 1936

Advanced Accounting No. 1. —Question 6

The Baldwin Corporation manufactures two products, designated respectively as X and Y. Processing is done in four departments known as A, B, C, and D, but product X is processed only in Departments A and B, while product Y is processed in Departments A, B, C and D. The production of each department is processed alike in every respect regardless of the product into which it is finally manufactured.

During the month of April, 1935, the expenses of each Department were:

	Dept. A	Dept. B	Dept. C	Dept.D
Direct Material	$51,000	.....	$1,500	$4,800
Direct Labour	24,000	$33,900	4,500	8,100
Fixed Charges	3,000	6,000	2,400	1,500
Opportioned Charges	7,500	6,000	2,400	1,500

The production record for the month of April showed the following:—

	Dept. A	Dept. B	Dept. C	Dept. D
Number of pounds started in process	900,000	810,000	420,000	380,000
Number of pounds finished	810,000	720,000	380,000	280,000
Number of pounds in process April 30th ..	90,000	90,000	40,000	100,000

Of the 720,000 pounds finished in Department B, 300,000 pounds became Product X without further work. The remainder of the product was transferred to Department C for further processing. Unfinished work in each department is estimated to be one-half finished, including material and all expenses in the department in which it is located.

Prepare:

(1) Cost statement showing:

(a) The Cost per pound in each department.

(b) The Cost per pound at the end of each stage of production.

(c) The value of Work-in-Process remaining in each department.

(d) The value of each class of finished goods.

(2) Journal entries recording the transfer of department costs and inventories.

SOLUTION

	A	B	C	D
Direct Material	$51,000	$	$ 1,500	$ 4,800
Direct Labor	24,000	33,900	4,500	8,100
Fixed Charges	3,000	6,000	2,400	1,500
Apportioned Charges	7,500	6,000	2,400	1,500
	85,500	45,900	10,800	15,900
Costs transferred from previous departments		81,000	67,200	71,060
	85,500	126,900	78,000	86,960
Remaining in Process	4,500	11,700	6,940	21,160
Remaining as Finished Goods.	......	48,000	.....	.....
Transferred to next department	81,000	67,200	71,060	65,800
	$85,500	$126,900	$78,000	$86,960

Quantities

Finished Units transferred	810,000	420,000	380,000	280,000
Finished Units completed		300,000		
Unfinished, in terms of finished units	45,000	45,000	20,000	50,000
Production in terms of finished units	855,000	765,000	400,000	330,000

Unit Costs

This Department	10c	6c	2.7c	4.8c
Transferred from previous Department		10	16	18.7
Cumulative	10c	16c	18.7c	23.5c

Journal Entries

1.	Work in Process Department A	$ 4,500	
	Department B	81,000	
	Department A		$ 85,500
2.	Work in Process Department B	11,700	
	Finished Goods Product X	48,000	
	Department C (420,000 X @ 16c)	67,200	
	Department B		126,900
3.	Work in Process Department C	6,940	
	Department D (380,000 @ 18.7c)	71,060	
	Department C		78,000
4.	Work in Process Department D	21,160	
	Finished Goods Y (280,000 @ 23.5c)	65,800	
	Department D		86,960